Supreme Court, U.S.
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No. 01-___

In The

Supreme Court of the United States

PENNZOIL COMPANY AND SUBSIDIARIES,

Petitioner,

v.

DEPARTMENT OF REVENUE, STATE OF OREGON

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Oregon

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Oregon Supreme Court's decision, subjecting to tax in Oregon a multibillion-dollar settlement payment that resolved a notorious 1985 Texas litigation between Petitioner Pennzoil Company and Texaco, Inc., arising from a *failed capital transaction,* resulted in extraterritorial taxation of out-of-state income in violation of the Due Process and Commerce Clauses of the United States Constitution.

2. Whether the Oregon Supreme Court misinterpreted this Court's decision in *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992), in holding that the multibillion-dollar settlement of that notorious litigation, resulting from a failed capital transaction, could constitutionally be taxed by Oregon, despite the fact that it was neither received from a payor with a unitary relationship to Petitioner nor attributable to a disposition of assets that had an operational connection to Petitioner's relatively *de minimis,* unrelated business activities within Oregon.

LIST OF PARTIES

The parties are as stated in the caption.

RULE 29.6 STATEMENT

Petitioner Pennzoil Company changed its name to PennzEnergy Company effective on or about December 30, 1998. On August 17, 1999, PennzEnergy Company was merged with Devon Energy Corporation. No publicly held company owns 10% or more of Devon Energy Corporation stock.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

LIST OF PARTIES ii

RULE 29.6 STATEMENT ii

TABLE OF AUTHORITIES vi

OPINIONS BELOW 1

JURISDICTION 1

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED 1

STATEMENT 2

The Facts 4

1. Pennzoil's Business and Its Oregon Activities... 5

2. The Generation of the Texaco Settlement Proceeds 5

3. Facts Revealed by Separate Accounting 8

4. Tax Policy Testimony 9

   a. Expert Report and Testimony of Walter Hellerstein 10

   b. Expert Report and Testimony of Richard D. Pomp 11

5. Oregon's Taxing System 13

6. The Assessment 15

7. The Proceedings Below 15

TABLE OF CONTENTS – Continued

Page

REASONS FOR GRANTING THE PETITION 17

I. INCLUSION OF THE TEXACO SETTLEMENT PROCEEDS IN PENNZOIL'S OREGON APPORTIONABLE INCOME RESULTS IN THE ATTRIBUTION OF INCOME TO OREGON THAT IS OUT OF ALL PROPORTION TO PENNZOIL'S ACTIVITIES IN THE STATE 17

A. This Court Has Held Repeatedly That States May Not Tax Values Earned Outside Their Borders 17

B. Including the Texaco Settlement Proceeds in Pennzoil's Taxable Income Apportionable to Oregon Results in Taxation of Pennzoil's Income Out of All Proportion to the Business Pennzoil Conducted in Oregon 18

a. The existence of a unitary business does not diminish the importance of separate accounting 20

b. Separate accounting remains a valuable measuring tool 20

II. STATES VIOLATE THE CONSTITUTIONAL MANDATE NOT TO TAX EXTRATERRITORIAL VALUES IF THEY FAIL TO LIMIT THEIR REACH TO INCOME RECEIVED BY A TAXPAYER FROM A PAYOR WITH WHOM IT HAS A UNITARY RELATIONSHIP, OR TO INCOME RESULTING FROM A TRANSACTION THAT SERVED AN OPERATIONAL PURPOSE 22

A. No Unitary Relationship Existed Between Texaco, the Payor, and Pennzoil 23

TABLE OF CONTENTS – Continued

Page

B. The Texaco Settlement Proceeds Did Not Arise from a Transaction That Served an Operational Purpose 24

III. THE OREGON SUPREME COURT'S EXPANSIVE CONSTRUCTION OF THE "OPERATIONAL" TEST TO COVER ANY GAIN THAT BENEFITED A TAXPAYER'S BUSINESS WOULD SUBVERT SETTLED CONSTITUTIONAL PRECEDENTS 26

CONCLUSION 30

APPENDICES

Appendix A:
Opinion of the Supreme Court of Oregon 1a

Appendix B:
Opinion of the Oregon Tax Court 13a

Appendix C:
Oregon Revised Statutes Involved 34a

Appendix D:
Expert Opinion of Professor Richard D. Pomp 38a

Appendix E:
Expert Opinion of Walter Hellerstein 47a

Appendix F:
Excerpt from Transcript of Oral Reargument in *Allied-Signal, Inc. v. Director, Div. of Taxation*, No. 91-615 (U.S. Apr. 22, 1992) 53a

TABLE OF AUTHORITIES

Page

CASES

Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992) ..... *passim*

ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982) ..... *passim*

Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983) 16, 18, 19, 22

Corn Prods. Refining Corp. v. Commissioner, 350 U.S. 46 (1955) 25

Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980) 17, 26

F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M., 458 U.S. 354 (1982) 26, 27

Hans Rees' Sons. v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931) 15, 16, 19, 21, 22

Miller Bros. v. Maryland, 347 U.S. 340 (1954) 16

Mobil Oil Corp. v. Commissioner of Taxes of Vt., 445 U.S. 425 (1980) 17, 23, 26

Moorman Mfg. Co. v. Bair, 437 U.S. 367 (1978) 21

National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753 (1967) 22

Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n, 390 U.S. 317 (1968) 18

Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175 (1995) 10

TABLE OF AUTHORITIES – Continued

Page

Quill Corp. v. North Dakota, 504 U.S. 298 (1992) 19, 22

W.R. Grace & Co. v. Commissioner of Revenue, 378 Mass. 577, 393 N.E.2d 330 (1979) 26

Willamette Indus., Inc. v. Department of Revenue, 331 Or. 311, 15 P.3d 18 (2000) 14

Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940) 17

CONSTITUTION

U.S. Const. art. I, § 8, cl. 3 ..... 1, 3

U.S. Const. amend. XIV, § 1 ..... 1, 3

LAW

Unif. Div. of Income for Tax Purposes Act, Prefatory Note, ¶ 7A Pt. I U.L.A. 357 (1957) 13

STATUTES

28 U.S.C. § 1257(a) 1

Or. Rev. Stat. § 314.610 13

Or. Rev. Stat. § 314.610(1) 14

Or. Rev. Stat. § 314.610(5) 14

Or. Rev. Stat. § 314.615 13

Or. Rev. Stat. § 314.650 14

Or. Rev. Stat. § 314.670 ..... 15, 21

Or. Rev. Stat. § 317.018 13

TABLE OF AUTHORITIES – Continued

Page

OTHER AUTHORITIES

I Karen J. Boucher & John C. Healy, *2000 Multistate Corporate Tax Guide* (2000) 20

Walter Hellerstein, *The Business-Nonbusiness Income Distinction and the Case for Its Abolition*, State Tax Today (Aug. 22, 2001) 4

Multistate Corp. Income Tax Guide (CCH) ¶ 145 13

PETITION FOR A WRIT OF CERTIORARI

This petition for a writ of certiorari respectfully seeks this Court's review of the October 4, 2001, judgment of the Supreme Court of Oregon.

OPINIONS BELOW

The opinion of the Supreme Court of Oregon (App. A at 1a-12a) is officially reported at 332 Or. 542, 33 P.3d 314 (2001). The final decision and judgment of the Oregon Tax Court (App. B at 13a-33a), from which an appeal was properly taken directly to the Supreme Court of Oregon, is not officially reported.

JURISDICTION

The judgment of the Supreme Court of Oregon was entered on October 4, 2001. The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Due Process Clause of the United States Constitution, U.S. Const. amend. XIV, § 1, provides: "[N]or shall any State deprive any person of life, liberty, or property, without due process of law. . . . "

Relevant portions of the Oregon statutes are set forth in Appendix C at 34a-37a.

STATEMENT

This Court has voiced its concern with states becoming too "piggy" in their attempts to tax income which has no connection to the taxing state.[1] Each year this Court receives several petitions for a writ of certiorari requesting review of decisions of state courts that have upheld overly aggressive and arguably unconstitutional attempts to tax income that has no connection to the business carried on by taxpayers in the jurisdiction. Left unchecked by this Court, these decisions will embolden the states to do precisely what this Court rejected in *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992) – to tax all income of a corporation regardless of how tenuous its threads are to the business carried on within the state.

The taxation by Oregon's Department of Revenue ("Department") of the $2.1 billion settlement proceeds received in 1988 by Pennzoil Company and Subsidiaries ("Pennzoil" or "the Company") from Texaco, Inc. ("Texaco") (the "Texaco Settlement Proceeds") epitomizes how thoroughly the states have trodden over the Constitution and this Court's precedent and just how "piggy" states have become. The settlement ended a case which, at the time, had produced the largest jury verdict in the country and was attributable to tortious interference by Texaco with Pennzoil's agreement to purchase a minority stock interest in Getty Oil Company ("Getty"). Thus, the settlement was the result of a *failed capital transaction.*

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[1] *See* Excerpt of transcript of oral reargument in *Allied-Signal, Inc. v. Director, Division of Taxation,* No. 91-615 (U.S. Apr. 22, 1992) set forth as Appendix F at 53a-55a.

By including such extraordinary, once-in-a-corporate-lifetime settlement proceeds in Pennzoil's Oregon income, the tax assessment (the "Assessment") issued by the Department results in constitutionally impermissible extraterritorial taxation.

The Oregon Supreme Court's decision violates the Constitution and prior decisions of this Court in two important and closely related respects, each of which separately requires the reversal of the decision below.

First, the Oregon decision ignores the well-established rule that, whatever method a non-domiciliary state chooses to apportion the income of a multi-state business, no state can tax more than a "rough approximation" of what was earned within that state. In this case, the Supreme Court of Oregon in effect held that whenever a state uses a generally accepted method of apportionment, such as the three-factor formula, every capital transaction is apportionable, no matter how unique, how large, how distortive and how unrelated to the business conducted within the state. The result is the extraterritorial taxation by Oregon of billions of dollars of income unrelated to Oregon, earned outside its borders, in violation of the Due Process and Commerce Clauses of the U.S. Constitution.

Second, the Oregon Supreme Court confuses and misstates the very nature of the "unitary business" principle, long relied upon by this Court as a basis for state taxation of multi-state businesses, and also incorrectly applies the holding by this Court in *Allied-Signal* that a capital transaction which serves an investment function, rather than an operational function, cannot be taxed by a non-domiciliary state. The Oregon court's decision has so broadly interpreted the "operational function" standard

articulated by this Court in *Allied-Signal* so as to make the test meaningless.

Under either of these constitutional tests, the decision of the Oregon Supreme Court should be reversed. Further, without guidance on the limitations of the "operational function" test, more states are bound to join Oregon in the quest to push the apportionment envelope beyond its breaking point. A decision by this Court will clarify the contentious and oft-litigated area that affects virtually all multijurisdictional corporations throughout the country, an area which one renown tax authority has called "a mess."[2]

The Facts

The facts of this case are not in dispute. They arise out of events that were covered on the front page of every newspaper in America and were the subject of several books – Pennzoil's 1984 arrangement to buy a 3/7 stock interest in Getty Oil; Texaco's tortious interference with that arrangement; a 1985 lawsuit in Houston resulting in an unprecedented jury verdict of nearly $11 billion, including $3 billion in punitive damages; the subsequent bankruptcy of Texaco; and a 1987 negotiated settlement with Texaco's creditors committee. None of these events had the slightest connection to Oregon or to Pennzoil's limited business activities within the state.

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[2] Walter Hellerstein, *The Business-Nonbusiness Income Distinction and the Case for Its Abolition*, State Tax Today (Aug. 22, 2001).

1. Pennzoil's Business and Its Oregon Activities

During all of the period in which important activities occurred, Pennzoil was a Delaware corporation, with its principal place of business in Texas. It and its subsidiaries were engaged in the business of exploration and production of oil and natural gas, and the production of motor oil and related products. As the Oregon Supreme Court found, the only business Pennzoil conducted in Oregon during 1988, the tax year at issue here, was the operation of a facility for blending, packaging and distributing motor oil and related automotive products. (App. A at 3a.) Further, as the Oregon Supreme Court acknowledged, none of the employees at that facility played any role in generating the settlement with Texaco, or had any connection to the underlying activities giving rise to the litigation or the settlement. (App. A at 3a.) Also, as found by the Oregon Supreme Court, the Oregon facility operated at a loss during 1988, as it had in the two preceding years, and the Department's own auditor recognized that Pennzoil's activities in Oregon during 1988 were no different than they had been during the previous two loss years. (App. A at 3a-4a.)

2. The Generation of the Texaco Settlement Proceeds

In late 1983, Pennzoil's senior management, having read newspaper accounts of turmoil within Getty, perceived an investment opportunity in Getty. Pennzoil's management believed a minority stock interest would be an attractive and potentially lucrative investment, and made an unsolicited tender for 20% of the Getty shares.

Pennzoil had no contemplation of achieving anything other than a minority stock ownership.

At Pennzoil management's first meeting with Getty ownership after the tender offer was announced, to Pennzoil's own surprise, they came to an almost immediate agreement for Pennzoil to purchase a 3/7 interest in Getty stock, with Gordon Getty, heir to the late J. Paul Getty, to retain a majority interest of 4/7 and to be Chairman of the Board. (App. A at 2a.) A Memorandum of Agreement, signed by both sides, recited the plan for Pennzoil to acquire 3/7 of the Getty stock, and a pledge to endeavor in good faith to restructure Getty or to liquidate and distribute unsold assets.

The Getty Board then held extraordinary meetings in New York City, lasting into the small hours of January 3, 1984, to consider the Pennzoil offer, and to propose counter-offers (which were slipped under the hotel room doors of the Pennzoil representatives during the night). The Board demanded and received an increase in the purchase price before approving the agreement. Press releases were issued by both Pennzoil and Getty on January 4, 1984, announcing the deal.

However, final deal documents were never completed, due to repeated rebuffs and delays by the Getty side, until the Pennzoil team awoke to a surprise public announcement on January 6, 1984, that Texaco would acquire all of Getty's stock. (App. B at 14a.) Texaco also agreed to provide three indemnities, one to Gordon Getty, one to the J. Paul Getty Trust, and one to Getty management.

The immediate result was nationwide litigation, beginning with a lawsuit filed by Getty seeking a declaratory judgment that it was not bound by any alleged

contract with Pennzoil. The requested relief was denied. Pennzoil then filed an action in Delaware Chancery Court seeking specific performance, which was also denied (App. B at 14a), despite the court's finding that Pennzoil was likely to ultimately prevail, because so many shares of stock had already changed hands that untangling the deal would have been all but impossible. The acquisition by Texaco was completed in February 1984. (App. B at 14a.)

Then, in a much-heralded piece of litigation strategy, Pennzoil instituted a new suit against Texaco in Texas District Court, seeking damages for tortious interference with its contract to acquire the shares of Getty. (App. B at 14a-15a.) Thus began a litigation that involved teams of large national law firms, a famous Texas jury trial lawyer, vitriolic charges and countercharges, and millions of dollars spent on trial preparation and expert witnesses. Pennzoil sought punitive damages as well as compensation for Texaco's tortious activity, and relied on several theories of damages. The theory that resulted in the largest possible damage award was based on valuing the stolen opportunity to purchase Getty stock by reference to oil and gas prices. To the surprise of many observers, Texaco's litigation strategy allowed Pennzoil's evidence on damages to stand unrebutted, a strategy that backfired badly when the jury returned a stunning verdict in favor of Pennzoil – the largest ever at the time – holding Texaco liable for tortious interference with what was found to be a valid, albeit short-lived, agreement for the purchase of a minority interest in Getty, and assessing actual damages of over $7 billion. The jury also awarded punitive damages of $3 billion, generated by Texaco's three indemnities (awarding $1 billion for each), reflecting the jury's

belief that the indemnities proved knowing interference with an existing contract.

In 1987, after failing to set aside the jury verdict, Texaco voluntarily sought Chapter 11 Bankruptcy protection, and Pennzoil became its single largest creditor – by a substantial margin – and thus opposed in interest not only to Texaco but to most of the other creditors.

Eventually, four years after it first conceived the plan to buy a minority interest in Getty, Pennzoil settled with Texaco, and agreed to accept a payment of $3 billion. (App. A at 3a.) The number bore no relationship to the value of oil and gas reserves owned by Getty four years earlier, or to any specified piece of the jury's damage award, and was accepted by Pennzoil only because its management believed that figure to be the maximum amount Pennzoil could obtain that would be acceptable to the other creditors, and perhaps the shareholders suing Texaco, and would not cripple Texaco.

Of the $3 billion settlement payment, $2,088,840,587 was included in federal taxable income, and this amount, the Texaco Settlement Proceeds, was treated by the Oregon auditor as allegedly apportionable to Oregon. (App. A at 3a-4a.) The result of including the Texaco Settlement Proceeds in the Oregon tax base was that Oregon taxable income ballooned from approximately $600,000 to almost $8 million, an almost thirteen-fold, or 1300%, increase.

3. Facts Revealed by Separate Accounting

Under the Department's formulary apportionment approach, Pennzoil's alleged net taxable Oregon income for 1988 was nearly $8 million. The uncontroverted separate accounting analysis, performed by a representative of the Arthur Andersen accounting firm, revealed that

Pennzoil's actual net taxable Oregon income for 1988 was a *loss* of over $1 million.

Comparison Summary

	As Filed	Separate Accounting	Per Oregon Supreme Court[3]
Oregon Gross Receipts	$13,369,762	$13,369,762	$13,369,762
Oregon Net Taxable Income	612,588[4]	(1,067,629)	7,941,182
Oregon Taxable Income As A Percentage of Gross Receipts	4.58%	N/A	59.40%

4. Tax Policy Testimony

At the trial, Pennzoil introduced the unrebutted testimony of two of the nation's leading tax policy experts and scholars, Professor Walter Hellerstein and Professor Richard D. Pomp.

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[3] Other issues at trial concerned the inclusion of certain items in Petitioner's apportionment factors, and these issues were resolved by the Tax Court in the Petitioner's favor. The figures in the "Per Oregon Supreme Court" column reflect the inclusion of these items in the factor.

[4] Although Petitioner had an actual loss in Oregon, Petitioner reported taxable income on its consolidated Oregon tax return due to apportionment of operating income.

a. Expert Report and Testimony of Walter Hellerstein

Walter Hellerstein, one of the country's foremost experts on questions involving the constitutional constraints imposed upon state and local taxes, is the coauthor of the leading treatise in the field, Jerome R. Hellerstein and Walter Hellerstein, *State Taxation* (1983); a casebook in the field, Jerome R. Hellerstein and Walter Hellerstein, *State and Local Taxation;* and approximately 50 articles published in scholarly journals. This Court has cited Professor Hellerstein's work in more than a dozen opinions. *See, e.g., Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995). He has testified on behalf of states and private industry.

Professor Hellerstein's expert report, set forth as Appendix E at 47a-52a, and his testimony confirm his opinion that "Oregon has no authority to tax the Texaco Settlement Proceeds." (App. E at 47a.) Professor Hellerstein summarized the basis for this opinion as follows: "[T]he only link between Oregon and the Texaco Settlement Proceeds is speculation about the future use that Pennzoil might have made of its planned – but ultimately, abortive – investment in Getty. Such an attenuated connection does not constitute the minimum connection or definite link that is the prerequisite of Oregon's power to tax such proceeds." (App. E at 50a.) Professor Hellerstein emphasized that the proceeds derived from a lawsuit that had no connection with Oregon, and that there is no basis for looking to the stock or to Getty's assets as the source of the income. Professor Hellerstein also emphasized that the fact that damages were measured by the hypothetical economic benefit of acquiring Getty's reserves has no

bearing on whether Oregon may tax the Settlement Proceeds. (App. E at 50a.)

Furthermore, Professor Hellerstein opined that he had "never seen a transaction as unusual, irregular, almost bizarre" and that "[i]t would be hard to find a transaction that is less easily characterized as a transaction in the regular course of the taxpayer's trade or business or an integral part of the taxpayer's trade or business than a once-in-a-corporate-lifetime payment from the settlement of a lawsuit." (App. E at 51a.)

Finally, Professor Hellerstein opined that "if the Texaco Settlement Proceeds were included in Pennzoil's Oregon apportionable tax base, the resulting apportionment would attribute to Oregon income out of all appropriate proportion to Pennzoil's activities in the state and create a grossly distorted result." (App. E at 51a.) Including the Texaco Settlement Proceeds in Plaintiffs' tax base "on its face" "would be distortion."

b. Expert Report and Testimony of Richard D. Pomp

Professor Pomp, accepted as an expert in tax policy, has lectured, taught, consulted on, and testified in connection with state tax matters for 25 years. He has testified on behalf of state governments, and consulted with the U.S. Treasury, the Department of Justice, and the Multistate Tax Commission.

Professor Pomp was asked to evaluate whether, under principles of tax policy, Oregon had a sufficient relationship to the Texaco Settlement Proceeds to justify the state's assertion of taxing jurisdiction over those proceeds. In Professor Pomp's opinion, set forth as Appendix D at 38a-46a, "the settlement proceeds paid by Texaco

have no relationship with Oregon and should not, under normative principles of state tax policy, be apportioned to that State." (App. D at 46a.) This conclusion is based on Professor Pomp's opinions that "Oregon had no connection or relationship to the settlement proceeds that Pennzoil received from Texaco," and "[t]he Texaco litigation did not arise out of the ordinary everyday business operations of Pennzoil." (App. D at 40a.) Moreover, according to Professor Pomp, Oregon cannot tax the Texaco Settlement Proceeds based upon either speculation about what might have happened if Pennzoil had acquired the Getty stock, which in testimony Professor Pomp termed "wishful thinking nexus," or the fact that the jury based its damages award on the value of Getty's oil reserves. (App. D at 41a-42a.)

In Professor Pomp's opinion, two factors particularly compel the conclusion that taxing the Texaco Settlement Proceeds would be inconsistent with principles underlying Oregon's apportionment formula. (App. D at 43a-45a.) First, the premise of the formula is that it uses the same factors to apportion the income (payroll, sales, and property) that actually generated the income; however, "[n]o Oregon factor . . . helped generate the [S]ettlement [P]roceeds." (App. D at 44a.) Second, because the formula is not scientific (*i.e.*, "[t]here is no economic theory or model upon which the formula is based"), it depends upon errors and slippages to wash out over time; however, if income of the magnitude of the Texaco Settlement Proceeds is included in the tax base, it will never self-correct. (App. D at 44a-45a.) As Professor Pomp testified, "you can't count on defects in the formula working themselves out in subsequent years." In this light, applying Oregon's apportionment formula to the

Texaco Settlement Proceeds, according to Professor Pomp, results in "obvious overreaching." (App. D at 45a.)

5. Oregon's Taxing System

Like most other states, Oregon uses a corporate taxpayer's federal taxable income as the starting point for determining Oregon taxable income. Or. Rev. Stat. § 317.018. For corporations conducting business within and without the State, Oregon determines the share of the taxpayer's income attributable to the State pursuant to a tax statute based upon a model act known as the Uniform Division of Income for Tax Purposes Act, or UDITPA. Adopted in whole or in large part by at least 20 states and the District of Columbia, UDITPA is designed to distribute a multi-state entity's taxable income across the jurisdictions in which it operates in a manner that is uniform and that minimizes multiple taxation. Unif. Div. of Income for Tax Purposes Act, Prefatory Note, 7A Pt. I U.L.A. 357 (1957); Multistate Corp. Income Tax Guide (CCH) ¶145.

UDITPA attempts to accomplish its aim of equitable distribution of income, first, by separating those items of income properly subject to tax by all of the states in which a taxpayer operates its business from those items of income properly subject to tax by only a single state. The former category of income is termed "business income," and the latter, "nonbusiness income." Once the items of income are properly classified, UDITPA "allocates" each item of nonbusiness income, in full, to a single jurisdiction, pursuant to specified rules. Or. Rev. Stat. §§ 314.610, 314.615. UDITPA then distributes, or "apportions," the remaining income (*i.e.*, the business income) among the states in which the taxpayer conducts

its business pursuant to a stated formula. Or. Rev. Stat. § 314.650.

Oregon law defines "business income" in the following manner:

> "Business income" means income arising from transactions and activity in the *regular* course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, . . . and the disposition of the property constitute *integral* parts of the taxpayer's *regular* trade or business operations.

Or. Rev. Stat. § 314.610(1) (emphasis added). "Nonbusiness income" is defined as "all income other than business income." Or. Rev. Stat. § 314.610(5).

Oregon, like a number of other states, has adopted a two-part test for identifying business income, the "transactional test," and the "functional test." *Willamette Indus., Inc. v Department of Revenue*, 331 Or. 311, 15 P.3d 18 (2000). The transactional test focuses on the first part of UDITPA's definition of "business income" – the reference to "income arising from transactions and activity in the regular course of the taxpayer's trade or business" – and asks whether the transactions giving rise to the item of income in question represent normal or customary activities within the taxpayer's business. *Willamette*, 331 Or. at 316, 15 P.3d at 21. The functional test arises from the second part of UDITPA's definition of "business income," and asks whether the acquisition, management and disposition of the property were an integral part of the taxpayer's regular business.

Whether or not a particular item of income of an out-of-state taxpayer is found to be business income under Oregon's statute, it still cannot be subject to tax if the

result does not fairly represent the extent of the taxpayer's activity in the state. Oregon recognizes this overriding principle in the statute, section 314.670, which is also a part of UDITPA, into which it was adopted as a codification of the standard established by this Court long ago in *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931), forbidding the taxation of extraterritorial values.

The Oregon Supreme Court found that the Texaco Settlement Proceeds were business income under the transactional test, and thus did not consider the functional test. It did consider and reject as "[m]odernly . . . of limited value," the *Hans Rees'* principle. (App. A at 11a, n. 4.)

6. The Assessment

On August 4, 1997, Oregon issued a Notice of Assessment for Oregon Corporation Excise Tax of $718,932 to Pennzoil. By Complaint filed on October 2, 1997 with the Oregon Tax Court, Pennzoil's appeal of the Notice of Assessment was timely. At the Oregon Tax Court, the auditor reduced the principal amount of the assessment to $597,877, and the court confirmed the reduction.

7. The Proceedings Below

How the federal question was raised and passed on below. In its pleadings and briefs filed below, Pennzoil consistently raised two arguments of constitutional significance. First, Pennzoil argued that the assessment resulted in gross, unconstitutional, extraterritorial taxation of activities unrelated to Pennzoil's business in Oregon. Pennzoil argued that this Court nas repeatedly

decreed that a state tax system may only tax that portion of an out-of-state company's income that is earned within the state. Although formulary apportionment is designed to, and generally does, roughly approximate that portion, where a state's approach – even when applied to a unitary business – taxes more than that portion, the state has exceeded constitutional boundaries. Pennzoil argued that the Department's assessment exceeds those parameters and unconstitutionally taxes income in a manner out of all reasonable proportion to the activities conducted within Oregon.

Second, Pennzoil argued that the Department was prohibited from taxing the settlement proceeds under the Due Process and Commerce Clauses of the United States Constitution, since the State lacks nexus over the transactions and activities that generated the income. Pennzoil has argued consistently that Oregon cannot tax the Texaco Settlement Proceeds since they were not paid to Pennzoil by an entity that conducted a unitary business with Pennzoil and did not arise from a transaction that served an operational purpose, within the meaning of this Court's decision in *Allied-Signal.*

With regard to both legs of its constitutional arguments, Pennzoil relied below on a number of this Court's decisions, including *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992); *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159 (1983), *Miller Bros. v. Maryland,* 347 U.S. 340 (1954), and *Hans Rees' Sons v. North Carolina ex rel. Maxwell,* 283 U.S. 123 (1931).

The decisions below. Pennzoil's claims under the United States Constitution were raised in the Complaint it filed with the Oregon Tax Court. On March 17, 2000, the Tax Court entered its opinion upholding the assessment

and, *inter alia*, rejecting Pennzoil's constitutional arguments. (App. B at 13a-33a.)

Pennzoil timely appealed the Tax Court's decision to the Supreme Court of Oregon. The State Supreme Court issued its decision affirming the Tax Court's opinion and rejecting Pennzoil's constitutional arguments on October 4, 2001. (App. A at 1a-12a.)

REASONS FOR GRANTING THIS PETITION

I.

INCLUSION OF THE TEXACO SETTLEMENT PROCEEDS IN PENNZOIL'S OREGON APPORTIONABLE INCOME RESULTS IN THE ATTRIBUTION OF INCOME TO OREGON THAT IS OUT OF ALL PROPORTION TO PENNZOIL'S ACTIVITIES IN THE STATE

A. This Court Has Held Repeatedly That States May Not Tax Values Earned Outside Their Borders.

It is among the most fundamental precepts of state taxation that a non-domiciliary state may not tax values earned outside it. A tax on interstate activities will withstand scrutiny under the Due Process and Commerce Clauses of the U.S. Constitution only if there exists "a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.' " *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 219-20 (1980) (quoting *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436, 437 (1980)); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982) ("As a general principle, a State may not tax value earned outside its borders."). Where no such connection exists, the state has not "given anything for which it can ask return." *Wisconsin v. J.C. Penney Co.*,

311 U.S. 435, 444 (1940); *see also ASARCO*, 458 U.S. at 315; *Norfolk & W. Ry. Co. v. Missouri State Tax Comm'n*, 390 U.S. 317, 326-31 (1968).

As this Court stated in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169-70 (1983):

> [A]n apportionment formula must, under both the Due Process and Commerce Clauses, be fair . . . . The Constitution does not "invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State. . . . " Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in the State' or has 'led to a grossly distorted result.' "

(Citations omitted.)

Thus, as this Court has consistently recognized, where an apportionment formula – whatever that formula might be – apportions income to a state "out of all appropriate proportion" to the business conducted, the Constitution has been violated.

B. Including the Texaco Settlement Proceeds in Pennzoil's Taxable Income Apportionable to Oregon Results in Taxation of Pennzoil's Income Out of All Proportion to the Business Pennzoil Conducted in Oregon.

Pennzoil had minimal operations in Oregon – one small plant – during the year in issue. Pennzoil's Oregon operation neither affected nor was affected by the events leading up to receipt of the Texaco Settlement Proceeds. Further, Pennzoil's Oregon operation sustained a loss in

the year at issue, as well as in the two years preceding Pennzoil's receipt of the Texaco Settlement Proceeds, and the Oregon operations remained identical during those three years. Finally, separate accounting unequivocally established that inclusion of the Texaco Settlement Proceeds in Pennzoil's Oregon tax base resulted in gross distortion – separate accounting resulted in a *taxable loss* of more than $1 million, while Oregon's inclusion of the proceeds resulted in almost $8 million of alleged Oregon net *taxable income*, on Oregon gross receipts of $13,369,762.

Inclusion of the Texaco Settlement Proceeds in the apportionment formula resulted in Oregon net taxable income that was almost *13 times*, or 1300%, greater than that derived without such inclusion. Additionally, inclusion of the Texaco Settlement Proceeds resulted in Oregon net taxable income of almost 60% of Oregon gross receipts; exclusion of such settlement proceeds resulted in less than 5% of Oregon gross receipts being taxed, a realistic profit margin for an operating business. The distortion resulting from the inclusion of the Texaco Settlement Proceeds resulted in distortion of significantly greater magnitude, 1300%, than that found to be insufficient by this Court in *Container Corp.*, 14%, and surpasses the 250% distortion found by this Court in *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931), as causing an unconstitutional result. Further, it can hardly be said that Pennzoil's income attributed to Oregon for tax purposes was "rationally related to 'values connected to the taxing State.' " *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992) (citation omitted).

a. The existence of a unitary business does not diminish the importance of separate accounting

The Oregon Supreme Court rejected the separate accounting because "Pennzoil conducted part of its unitary business in Oregon." (App. A at 12a.) The Oregon Court misunderstands the nature of the separate accounting introduced by Pennzoil. Rather than being precluded by a unitary business, a separate accounting test measures whether formulary apportionment, when applied to a unitary business, arrives at a roughly correct result.

Oregon's approach seems to be that, once a taxpayer is found to have conducted a unitary business with its subsidiaries, all gains from assets that might someday have benefitted the business are taxable. This is exactly what New Jersey tried to do in *Allied-Signal*, and was not permitted to do by this Court, which held:

> To be sure, our cases give States wide latitude to fashion formulae designed to approximate the instate portion of value produced by a corporation's truly multistate activity. But that is far removed from New Jersey's theory that any business in the State, no matter how small or unprofitable, subjects all of a corporation's out-of-state income, no matter how discrete, to apportionment.

504 U.S. at 784.

b. Separate accounting remains a valuable measuring tool

State statutes recognize that, when an apportionment formula overstates income, another method may be used. The laws of a substantial majority of the states, *including Oregon itself*, provide for the use of a separate accounting as a potential other method. *See* I Karen J. Boucher & John C. Healy, *2000 Multistate Corporate Tax Guide*, I-467 – I-471

(2000). Section 314.670 of the Oregon Revised Statutes provides:

> If the application of the allocation and apportionment provisions of ORS 314.605 to 314.665 do not fairly represent the extent of the taxpayer's business activity in this state, and result in the violation of the taxpayer's rights under the Constitution of this state or of the United States, the taxpayer may petition for and the department may permit, or the department may require, in respect to all or any part of the taxpayer's business activity:
>
> (1) Separate accounting;
>
> (2) The exclusion of any one or more of the factors;
>
> (3) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In a decision that has stood the test of time, this Court relied on the results of a separate accounting in *Hans Rees'* to find that North Carolina's apportionment method attributed to the state a percentage of income out of all appropriate proportion to the business transacted within the state. 283 U.S. at 135.

In *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), this Court rejected a challenge to the application of Iowa's apportionment formula, finding that the taxpayer had not demonstrated that out-of-state income was being taxed. This Court specifically noted that "the record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations." *Id.* at 272.

In *Container Corp.*, this Court recognized that some percentage of distortion would be unconstitutional, although it did not find that percentage to be reached. The Oregon Supreme Court has taken it upon itself to "disapprove" of the separate accounting method, finding this Court's decision in *Hans Rees'* to be "[m]odernly of limited value." (App. A at 11a, n. 4.) In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reminded litigants not to disregard standing precedents, and affirmed the continued validity of *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), which many states were asserting, as the Oregon Supreme Court has done with *Hans Rees'* herein, was of no relevance in the modern world. Separate accounting is a valuable method of testing an apportionment formula, and the Oregon Supreme Court was wrong to dismiss it.

II.

STATES VIOLATE THE CONSTITUTIONAL MANDATE NOT TO TAX EXTRATERRITORIAL VALUES IF THEY FAIL TO LIMIT THEIR REACH TO INCOME RECEIVED BY A TAXPAYER FROM A PAYOR WITH WHOM IT HAS A UNITARY RELATIONSHIP, OR TO INCOME RESULTING FROM A TRANSACTION THAT SERVED AN OPERATIONAL PURPOSE

In *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), this Court clarified its longstanding rules concerning the unitary business principle. This Court held that a gain incurred by an out-of-state company may be apportioned if it results from (a) payment from a payor with a unitary relationship to the taxpayer recipient; or (b) a capital transaction that served an operational purpose as opposed to an investment purpose. The Oregon Supreme Court seems to have ignored the basic duty to examine the relationship between the taxpayer and the payor and to have transformed these two

separate principles into one, stating that: "The unitary business principle supports a basis for apportionment. Specifically, states may apportion capital transactions that serve an operational function." (App. A at 10a.) As described below, the Oregon Supreme Court has seriously misstated this Court's delineation of the unitary business and "operational purpose" guidelines and has ignored the fact that the Texaco Settlement Proceeds did not relate to a capital transaction at all, but rather resulted from the unique situation where a capital transaction never occurred.

A. No Unitary Relationship Existed Between Texaco, the Payor, and Pennzoil.

This Court has stated that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 439 (1980); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 319 (1982) (quoting *Mobil*). The unitary business principle requires that a state establish some meaningful connection between the item of income it seeks to tax and the in-state activities of the taxpayer before it may tax any portion of that income. *See Allied-Signal*, 504 U.S. at 773. "[T]he existence of a unitary relation between the payor and the payee is one means of meeting the constitutional requirement." *Allied-Signal*, 504 U.S. at 787.

The Oregon Supreme Court never even made the right inquiry; it merely seems to have concluded that Pennzoil and its subsidiaries conducted a unitary business. It never made the relevant constitutional inquiry – whether there was a unitary relationship between Pennzoil and Texaco – as precedent dictates. Pennzoil may

have conducted a "unitary business" with its subsidiaries and affiliates, but Pennzoil was not unitary with Texaco.

B. The Texaco Settlement Proceeds Did Not Arise from a Transaction That Served an Operational Purpose.

In *Allied-Signal*, this Court recognized that the absence of a unitary relationship between a payor and a payee might not end the constitutional inquiry. The *Allied-Signal* decision reviewed New Jersey's attempt to tax a portion of a capital gain earned by the taxpayer, Bendix Corporation, from the sale of a 20.6% stock interest in another company, ASARCO. The parties had stipulated that "Bendix and ASARCO were unrelated business enterprises each of whose activities had nothing to do with the other," 504 U.S. at 774, and thus, there was no dispute that Bendix and ASARCO lacked a unitary relationship. Nonetheless, New Jersey contended that the gain at issue should be included in the apportionable tax base because, it claimed, Bendix regularly engaged in similar acquisitions and dispositions as part of a long-term corporate strategy, and the transaction was undertaken for business purposes. *Id.* at 786-88.

This Court rejected New Jersey's approach. While it acknowledged that prior decisions had analyzed the existence (or lack thereof) of a unitary relationship between the payor and payee of the relevant item of income, the Court stated that such a unitary relationship does not serve as the sole basis for a state's proper assertion of its tax. Indeed, the Court recognized that, where capital transactions are concerned, taxpayers may well lack a unitary relationship with the other party to the transaction, *e.g.*, a bank. *Id.* at 787-88. The Court explained that, in the absence of a unitary relationship, a state still may

tax income derived by an in-state taxpayer from capital transactions provided the state can demonstrate "that the capital transaction serve[s] an operational rather than an investment function" within the taxpayer's existing unitary business. *Id.* at 787. The Court concluded that New Jersey had failed to make such a showing. It determined that Bendix's equity stake in ASARCO represented a "passive investment" that was not "integral" to Bendix's operations, *id.* at 788, despite the stipulated fact that there were business purposes for the acquisition.

Here, Pennzoil was awarded the Texaco Settlement Proceeds because Texaco interfered with its acquisition of a minority interest in the Getty stock – the capital transaction was never consummated. Thus, there was no capital transaction which needed to be analyzed to determine whether it served an "investment" or "operational" function.

However, even if, *arguendo*, we were to assume that a capital transaction was effectuated, such transaction could not reasonably be viewed as serving an "operational" function to Pennzoil. In *Allied-Signal*, this Court provided two examples of "operational assets," short-term deposits of working capital and hedging transactions, such as that identified in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), neither of which is applicable here. Moreover, this Court's reference to the *Corn Products* case in the *Allied-Signal* decision as an example of what constitutes "operational" serves to establish how far afield the Texaco Settlement Proceeds are from being "operational." While the corn futures purchased were "vitally important to the company's business," *Corn Products*, 350 U.S. at 50, proceeds received as a result of litigation for tortious interference with an

agreement to purchase a minority interest in a corporation do not even remotely satisfy this Court's operational standard.

III.

THE OREGON SUPREME COURT'S EXPANSIVE CONSTRUCTION OF THE "OPERATIONAL" TEST TO COVER ANY GAIN THAT BENEFITED A TAXPAYER'S BUSINESS WOULD SUBVERT SETTLED CONSTITUTIONAL PRECEDENTS

Since the 1992 decision in *Allied-Signal* and its reference to the "operational" test as an alternative to the pure "unitary" test, many state departments of revenue have tried to tax all income of a multi-state taxpayer, attempting to reach gains arising from payors with no unitary relationship to the taxpayer. This approach – now adopted by the Oregon Supreme Court – ignores the principles established by this Court in the series of cases beginning with *Mobil* and *Exxon*, continuing through *ASARCO* and *Woolworth*, and culminating in the *Allied-Signal* decision itself.

The position accepted by the Oregon Supreme Court is similar to the argument made by state departments of revenue before *Woolworth* and *ASARCO*, and to the argument made by New Jersey and rejected in *Allied-Signal*. For example, in 1979 the Supreme Court of Massachusetts held that the gain generated by the W.R. Grace & Co.'s sale of its 52% stock investment in Miller Brewing was apportionable income and that, using a broad definition of Grace's business, the income from the sale of the Miller stock was allegedly "derived from business." *W.R. Grace & Co. v. Commissioner of Revenue*, 378 Mass. 577, 584, 393 N.E.2d 330, 334 (1979). The Massachusetts court relied heavily on the Idaho Supreme Court decision in

ASARCO, which was reversed by this Court three years later.

The reasoning of state decisions from the 1970's was soon decisively rejected by this Court. In *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982), the Court held that the fact that the United States Woolworth stores were engaged in the same general business as the foreign Woolworth stores – selling the same products, earning income from the same business operations, contributing to the company's wealth – was insufficient to permit inclusion in apportioned income of earnings from the foreign subsidiaries. On the same day, in *ASARCO*, this Court held that the business relationship between ASARCO and its majority owned subsidiary, Southern Peru – including significant purchases of product, provision of services, joint board members, and two closely related businesses – did not provide constitutional justification to tax ASARCO's gain from its sale of Southern Peru stock. Finally, this Court's analysis culminated in *Allied-Signal*, with the holding that New Jersey could not apportion Bendix's gain from the sale of stock in a company with which it had no unitary relationship.

Nothing in *Allied-Signal*'s references to the "operational" test overruled this Court's established jurisprudence on the constitutional importance of a unitary business relationship between payor and taxpayer. Indeed, this Court rejected New Jersey's argument, which had been endorsed by the New Jersey Supreme Court, that any income adding to the wealth of the taxpayer and arising from business motivations can be taxed. Such a conclusion, like that of the Oregon court below that the settlement proceeds can be taxed because, *if* Pennzoil

acquired Getty Oil, it *might* have had oil reserves which would have been useful in its business, would subsume the entire inquiry. As this Court held in *Allied-Signal*:

> The fact that a transaction was undertaken for a business purpose does not change its character. [In *ASARCO*,] Idaho had argued that intangible income could be treated as earned in the course of a unitary business if the intangible property which produced that income is " 'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.' " In rejecting the argument we observed:
>
> "This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently, *all* of its operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business. When pressed to its logical limit, this conception of the 'unitary business' limitation becomes no limitation at all."

Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 788-89 (1992) (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 326 (1982)).

It is just this sort of analysis that has been engaged in by the Oregon Supreme Court, in its confused statement that: "The unitary business principle supports a basis for apportionment. Specifically, states may apportion capital transactions that serve an operational function." (App. A at 10a.) The Oregon court concluded that, because Pennzoil was seeking oil reserves when it tried to acquire a minority interest in Getty Oil, and oil reserves were important to Pennzoil's business, the Texaco Settlement Proceeds somehow served an operational function. The

Oregon Supreme Court decision says no more and no less than this: oil reserves were related to Pennzoil's business, Pennzoil was trying to get oil reserves, and any compensation for failure to get oil reserves is either unitary or operational and therefore apportionable. The Oregon Supreme Court falls back on the tired old refrain relied on by countless state auditors since *Allied-Signal – if the gain arose out of a transaction related to the business' operations, it must be "operational."* That was not the test set forth by this Court in *Allied-Signal.* If that were the correct analysis, then this Court's decisions in both *ASARCO* and *Woolworth* must be deemed reversed, since clearly ASARCO's regular purchases of an essential mineral from Southern Peru were at least equally related to its business as Pennzoil's three-day ownership of an agreement to purchase a minority stock investment in Getty Oil, which owned oil reserves; and Woolworth's domestic business was at least equally related to its foreign Woolworth stores. Pennzoil, of course, never even acquired the stock of Getty Oil, much less any oil reserves, and it strains credibility to say that such phantom acquisitions somehow assumed an integral, operational role in Pennzoil's business. The Oregon Supreme Court's inspection of Pennzoil's corporate purpose, instead of the objective nature of the transactions actually engaged in – the largest single jury verdict in America's history, the finding that a major energy company had engaged in such malicious conduct that $11 billion in damages was awarded; the bankruptcy of Texaco; and a settlement to allow the company to survive – requires this Court to review and reverse the decision below and to provide guidance to all other state courts.

If Pennzoil's three-day interest in a disputed agreement to purchase 3/7 of the shares of Getty Oil can make a settlement payment by Texaco four years later an "operational" asset, there will be no limit whatsoever on the reach of a state's taxing power.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: December 28, 2001

APPENDIX A

Filed: October 4, 2001

IN THE SUPREME COURT OF THE STATE OF OREGON

PENNZOIL COMPANY AND
SUBSIDIARIES,

Appellants,

v.

DEPARTMENT OF REVENUE,
State of Oregon,

Respondent.

(OTC 4301; SC S47561)

On appeal from the Oregon Tax Court.*

Carl N. Byers, Judge.

Argued and submitted March 2, 2001.

Paul H. Frankel, of Morrison & Foerster LLP, New York, New York, argued the cause for appellants. Carol Vogt Lavine and Timothy R. Volpert, of Davis Wright Tremaine LLP, Portland, filed the briefs for appellants.

Marilyn J. Harbur, Assistant Attorney General, Salem, argued the cause for respondent. With her on the briefs was Hardy Myers, Attorney General.

Before Carson, Chief Justice, and Gillette, Durham, Leeson, Riggs and De Muniz, Justices.**

DE MUNIZ, J.

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* 15 OTR 101 (2000).

** Balmer, J., did not participate in the consideration or decision of this case.

The judgment of the Tax Court is affirmed.

DE MUNIZ, J.

The issue in this tax case is whether proceeds that taxpayer Pennzoil Company (Pennzoil) received in settlement of a tort judgment constitute business income under Oregon's tax code and, if so, whether apportionment of that income is constitutionally permissible. The Tax Court held that the proceeds were apportionable business income. *Pennzoil Co. v. Dept. of Rev.*, 15 OTR 101 (2000). For the reasons that follow, we affirm.

The facts are drawn from the parties' stipulations and the Tax Court's findings. In January 1984, Pennzoil agreed to purchase 3/7 of Getty Oil (Getty) stock. In return, Getty agreed to place Pennzoil officers in key positions on the Getty board of directors. The agreement provided that Pennzoil and the Getty Trust would be the sole owners of Getty, holding 3/7 and 4/7 of the company respectively. Another term of the agreement provided for the two shareholders to divide Getty's assets if Pennzoil and the Trust could not agree on a plan to restructure the company; those assets included Getty's substantial and proven oil and gas reserves.

A short time later, Pennzoil was surprised by a public announcement that Texaco had acquired *all* of Getty's stock. Pennzoil first sued Getty for specific performance in Delaware. After losing that action, Pennzoil sued Texaco in Texas for tortious interference with a contract. In that action, Pennzoil claimed damages based on the loss of its bargain with Getty in an amount equal to the cost of finding and developing one billion barrels of oil reserves.

A jury awarded Pennzoil more than $11.1 billion, including $3 billion in punitive damages. Texaco filed for Chapter 11 bankruptcy protection and, following a period of negotiation, Pennzoil agreed to accept $3 billion in satisfaction of the outstanding judgment.

Pennzoil received the settlement proceeds under a carefully structured payment plan, initially investing the money in high-grade securities.[1] Pennzoil segregated the securities from ordinary operating business accounts so that it could avoid classification as an "investment company" under federal securities law and take advantage of a federal tax exemption for income received by "involuntary conversion." The latter strategy was only partially successful. The Internal Revenue Service (IRS) applied the exemption to part of the proceeds, but decided that approximately $2.1 billion was taxable income for 1988. The question here is whether Oregon may apportion, for tax purposes, that $2.1 billion.

Pennzoil's only activity in Oregon during the 1988 tax year was the operation of a facility designed to blend, package, and distribute motor oil and related automotive products. None of Pennzoil's Oregon employees played a role in the Texas litigation or the negotiations that followed. In 1988, and the two years preceding, the Oregon

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[1] Pennzoil eventually used the proceeds to purchase about nine percent of Chevron Oil's common stock. *See Katz v. Chevron Corporation*, 22 Cal App 4th 1352, 1362, 27 Cal Rptr 2d 681 (1994) (shareholder derivative suit challenging corporate directors' defensive strategy in dealing with Pennzoil's purchase of 31.5 million shares for $2.1 billion).

facility operated at a reported loss. Pennzoil's 1988 Oregon tax return treated the settlement proceeds as nonbusiness income. However, the Department of Revenue (department) disagreed and assessed an additional corporate excise tax based on Oregon's share of the $2.1 billion. These proceedings ensued.

The Tax Court held that the proceeds were business income, subject to apportionment under ORS 314.650 (1987),[2] because: (1) the income arose from Pennzoil's agreement with Getty Oil; (2) Pennzoil's purpose in negotiating the Getty contract was to acquire some of Getty's oil reserves; (3) Pennzoil is in the business of acquiring and developing oil and gas reserves; (4) negotiating the contract with Getty was therefore in the regular course of Pennzoil's business; (5) the transaction with Getty was inherently an integral part of Pennzoil's regular business; and (6) income arising from that transaction was apportionable as business income under the Uniform Division of Income for Tax Purposes Act (UDITPA), ORS 314.605 to 314.670 (1987).

Pennzoil challenges the Tax Court's ruling in three assignments of error. First, Pennzoil asserts that the Tax Court erred in determining that the proceeds were "business income." Second, Pennzoil asserts that the Due Process and Commerce Clauses of the United States

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[2] ORS 314.650(1) (1987) provides:

> "(1) All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

Constitution prohibit Oregon from taxing the proceeds. Finally, Pennzoil asserts that the Tax Court erred by apportioning the proceeds under ORS 314.670 (1987) in a manner that grossly and unconstitutionally distorts Pennzoil's activity in Oregon.

We begin with Pennzoil's statutory argument. *See Stelts v. State*, 299 Or 252, 257, 701 P2d 1047 (1985) (pertinent statutes are considered before state and federal constitutions). Income earned outside Oregon may be apportioned if it is "business income." However, "nonbusiness income" that is earned elsewhere may not be apportioned.[3] Pennzoil asserts that the proceeds are "nonbusiness income" and, therefore, not subject to apportionment. "Nonbusiness income" is defined as "all income other than business income." ORS 314.610(5) (1987). "Business income" is

> "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

ORS 314.610(1) (1987).

Previously, this court has recognized that ORS 314.610(1) has two parts: (1) income derived from "transactions and activity in the regular course of the taxpayer's trade or business[;]" and (2) income derived from

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[3] Under UDITPA, "nonbusiness income" is allocated entirely to the state in which it was earned. ORS 314.625 to 314.645 (1987).

property "if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." *Willamette Industries, Inc. v. Dept. of Rev.*, 331 Or 311, 316, 15 P3d 18 (2000). Each part involves a separate test: part one requires a "transactional test" and part two requires a "functional test." If the income in question satisfies either test, then it may be apportioned as "business income." *Id.*

Under the transactional test, "business income" is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." The first question, therefore, is: What transaction or activity gave rise to the disputed income? *See Hoechst Celanese Corporation, v. Franchise Tax Board,* 106 Cal Rptr 2d 548, 563, 22 P3d 324 (2001) (nature of transaction or activity that gave rise to income is critical factor); *Western Natural Gas Co. v. McDonald,* 202 Kan 98, 101, 446 P2d 781 (1968) (same). In addressing that question, we may consider the frequency or regularity of the transaction and how the income created by the transaction is used. *Kemppel v. Zaino,* 91 Ohio St 3d 420, 422, 746 NE2d 1073 (2001); *Hoechst,* 106 Cal Rptr 2d at 563.

Here, the parties do not agree on what transaction or activity gave rise to the settlement proceeds. Pennzoil contends that the settlement proceeds arose from Texaco's tortious interference with the contract between Pennzoil and Getty. The department, however, asserts that the agreement itself gave rise to the proceeds. The Tax Court agreed with the department, concluding that

> "it does not matter whether the contract was sold, stolen, condemned, interfered with, or canceled; the income realized from it by Pennzoil was income *'arising from'* that contract."

15 OTR at 109 (emphasis added).

Pennzoil challenges the Tax Court's decision, arguing that that court ignored several important facts, including: (1) Texaco's agreement to indemnify Getty for any litigation arising out of the earlier deal between Getty and Pennzoil; (2) Texaco's bankruptcy; and (3) Texaco's creditors opposition to Pennzoil's efforts to enforce the judgment. Those facts, Pennzoil contends, illustrate that Texaco's conduct gave rise to the jury award and, ultimately, the settlement proceeds.

For many years, courts determining the tax consequences of income received through litigation or settlement have asked: "In lieu of what were the damages awarded?" *See, e.g., Raytheon Production Corporation v. Commissioner of Internal Revenue,* 144 F2d 110, 113 (1st Cir 1944) (discussing that recoveries that represent a reimbursement for loss of profits are "income"); *see also Getty v. Commissioner of Internal Revenue,* 913 F2d 1486, 1490 (9th Cir 1990) (maintaining that any accession to wealth received by taxpayer is presumed to be gross income includable in taxpayer's return); *accord Simpson Timber Company v. Dept. of Rev.,* 326 Or 370, 375, 953 P2d 366 (1998) (condemnation proceeds treated as income from voluntary sale of asset held by taxpayer for purpose of producing "business income"). Substantial evidence supports the Tax Court's finding that Pennzoil sought damages against Texaco based on the loss of its contract with Getty. *See* ORS 305.445 (setting out substantial evidence

standard of review). We conclude that Pennzoil received the settlement proceeds in lieu of its agreement with Getty and that the agreement gave rise to the disputed income.

The second question under the transactional test is: Did the agreement with Getty occur in the "regular course of [Pennzoil's] trade or business?" Again, we may consider the frequency or regularity of the transaction, and how Pennzoil used the resulting income. *Kemppel*, 91 Ohio St 3d at 422, *Hoechst*, 106 Cal Rptr 2d at 563. Pennzoil contends that the agreement with Getty was for stock, a transaction that Pennzoil characterizes as infrequent, irregular, and not in the course of its trade or business.

The department, on the other hand, observes that during Pennzoil's action against Texaco, Pennzoil repeatedly emphasized that the reason for its agreement with Getty was to gain access to Getty's oil reserves. That objective was reflected by a provision requiring Getty's assets to be distributed in the event that the two shareholders could not agree on a plan to restructure the company. Because Pennzoil's purpose was to acquire access to (or possession of) Getty's oil reserves, the department argues, it is reasonable to conclude that Pennzoil made the agreement in the regular course of its business, *i.e.*, extracting, processing, and selling petroleum, natural gas and minerals.

The frequency or regularity of a given transaction or activity may be considered but is not determinative of whether that transaction is in the "regular course of the taxpayer's trade or business"; neither is the manner in

which the taxpayer spends income created by that transaction. Thus, even if it is rare for Pennzoil to purchase stock in other oil companies – an argument weakened by the fact that Pennzoil used the settlement proceeds to acquire nine percent of Chevron Oil, *Katz*, 22 Cal App 4th at 1362 – we are persuaded that steps taken to acquire an interest in established oil reserves are steps taken in the "regular course of [Pennzoil's] trade or business." The Tax Court's finding that Pennzoil sought and received damages from Texaco based on the cost of developing one billion barrels of oil reserves supports that conclusion. We conclude that the proceeds are business income under the transactional test. Accordingly, it is unnecessary to apply the functional test.

Having resolved the statutory question, we turn to Pennzoil's second assignment of error. Pennzoil argues that Oregon's apportionment of the proceeds violates limitations imposed under the Due Process and Commerce Clauses of the United State [sic] Constitution. Under those clauses, states may tax income that is earned elsewhere only if there is "some definite link, some minimum connection, between [the taxing] state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland*, 347 US 340, 344-45, 74 S Ct 535, 98 L Ed 744 (1954). The constitutional parameters for taxing nondomiciliary corporations are defined by the unitary business principle that permits states to "tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State." *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 US 768, 778, 112 S Ct 2251, 119 L Ed 2d 533 (1992).

The unitary business principle supports a basis for apportionment. Specifically, states may apportion capital transactions that serve an operational function. *Allied-Signal,* 504 US at 787. Taxpayers challenging apportionment must prove that "the income was earned in the course of activities unrelated to [those carried out in the taxing] State." *Id.* (quoting *Mobil Oil Corp. v. Commissioner of Taxes of Vt.,* 445 US 425, 439, 100 S Ct 1223, 63 L Ed 2d 510 (1980) (brackets in original)).

Pennzoil argues that its unitary business was unaffected by the agreement with Getty or by Texaco's interference with the agreement and that the disputed income has no role in Pennzoil's Oregon operations. We are not persuaded. As already explained, the agreement between Pennzoil and Getty generated $2.1 billion of income that Texaco paid in lieu of Pennzoil's right to acquire an interest in Getty's oil reserves. The acquisition of oil reserves is related – indeed is vitally important – to the continued blending and distribution of motor oil in Oregon. *See Corn Products Refining Co. v. Commissioner,* 350 US 46, 50, 76 S Ct 20, 100 L Ed 29 (1955) (taxpayer's purchase of corn futures to insure adequate supply of raw material was "vitally important to the company's business"). Pennzoil has failed to meet its burden. The disputed income arose from activity that serves an operational function and, therefore, Oregon may apportion that income.

Pennzoil's third and final assignment of error asserts that its 1988 assessed tax liability in Oregon is unconstitutional because it is out of proportion with the amount of business it actually did in the state. Pennzoil argues that

formulary apportionment of the proceeds is *per se* unconstitutional, because it results in a tax liability that is approximately 844% larger than it would have been under a separate accounting method.[4] As we understand Pennzoil's argument, Oregon must sever large capital transactions from unitary business income, because state apportionment of business income is limited to business income generated within the state. In other words, Pennzoil argues that the unitary business principle does not apply to large capital transactions.

Our answer to Pennzoil's argument mirrors the Tax Court's. First, we disapprove of the separate accounting method that Pennzoil advocates. Indeed, the difficulty in applying a separate accounting method to a multistate business is the very reason for apportionment and the unitary business principle. Second, if Oregon could sever a single capital transaction from unitary business income

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[4] In support of its argument, Pennzoil relies on *Hans Rees' Sons v. North Carolina ex rel Maxwell*, 283 US 123, 51 S Ct 385, 75 L Ed 879 (1931), in which the Supreme Court held that, although the taxpayer's business was unitary, the statutory apportionment method operated "unreasonably and arbitrarily," because it attributed to the taxing state "a percentage of income out of all appropriate proportion to business transacted" in the state. *Id.* at 135.

Modernly, *Hans Rees'* is of limited value because Oregon, like the majority of states, has a multi-factor apportionment formula and, so far, the Court has refused to test the application of a multi-factor apportionment formula to a unitary multistate business by the principles of separate accounting. *See Development in the Law – Federal Limitations on State Taxation of Interstate Business*, 75 Harv L Rev 955, 1015 (1962) (discussing judicial treatment of apportionment formulas).

simply because apportionment of that income would result in distortion, then there would be little point in maintaining the unitary business principle. Pennzoil's unitary business succeeded in 1988 largely because of the settlement proceeds received from Texaco. In 1988, Pennzoil conducted part of its unitary business in Oregon. As a result, Oregon is entitled to apportion the settlement proceeds as unitary business income.

The judgment of the Tax Court is affirmed.

APPENDIX B

IN THE OREGON TAX COURT
REGULAR DIVISION
Corporate Excise Tax

PENNZOIL COMPANY AND SUBSIDIARIES, Plaintiff, v. DEPARTMENT OF REVENUE, State of Oregon, Defendant.	)	Case No. 4301 OPINION [Filed Mar. 17, 2000]

Pennzoil and its subsidiary corporations (collectively referred to as Pennzoil) appeal from an assessment of additional corporate excise taxes for the 1988 tax year. That assessment arose out of a very large tort settlement received by Pennzoil. Defendant Department of Revenue (the department) contends that the settlement proceeds constitute apportionable unitary business income. The parties stipulated to some facts, and a trial was held to receive evidence with regard to others.

FACTS

Although Pennzoil is a century-old Pennsylvania oil company name, it is a Delaware corporation with its principal place of business in Texas. During the years in question, Pennzoil constituted a vertically integrated business that explored for, produced, refined, packaged, and sold oil. It also engaged in business activities related to oil, natural gas, and minerals. Its only business activities in Oregon were the distribution and sale of motor oil

and related automotive products, and the activities of a small subsidiary. The Oregon subsidiary provided management information services to other Pennzoil operating subsidiaries and sold computer software.

In 1983, Pennzoil's chief executive officer saw an opportunity: Getty Oil Company (Getty Oil), with assets estimated in excess of $10 billion, was experiencing conflict among its major shareholders. Apparently, testamentary conditions imposed by the late J. Paul Getty were the source of internal discord, resulting in stock values that were far less than asset values. After receiving authorization from Pennzoil's board of directors, on December 28, 1983, Pennzoil made a "friendly" tender offer for 20 percent of the Getty Oil stock. Within days, Pennzoil and Getty Oil reached an understanding and began preparations to formalize their agreement. That understanding contemplated a merger of the two companies and a restructuring of Getty Oil.

Unbeknownst to Pennzoil, Texaco Inc. (Texaco), another large oil company, began secretly negotiating with Getty Oil to buy all of its stock. By January 6, 1984, Texaco had a new agreement with Getty Oil and the two companies merged on February 17, 1984.

Upon learning of the Texaco-Getty Oil agreement, Pennzoil sued Getty Oil for specific performance. When a Delaware court denied Pennzoil that equitable remedy, Pennzoil sued Texaco in Texas for improper interference

with a contract. The jury trial awarded Pennzoil a judgment for $11,120,976,110.83 in damages.[1] After Texaco's appeals were denied, it filed bankruptcy. This prompted negotiations between Pennzoil and Texaco, resulting in a settlement agreement. On April 7, 1988, Texaco paid Pennzoil $3 billion in satisfaction of Pennzoil's claims in accord with the settlement agreement.[2] When Pennzoil filed its 1988 Oregon consolidated excise tax return (amended), it treated the net settlement proceeds as nonbusiness, nonapportionable income.[3] The department disagreed with this characterization and assessed additional corporate excise taxes. Pennzoil then commenced this appeal.

ISSUES

Are the tort settlement proceeds unitary business income apportionable to Oregon? If so, should the gross proceeds from financial instruments in which the $3 billion was invested be included in the denominator of the sales factor?

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[1] District Court of Harris County, Texas, judgment entered December 10, 1985. *See* Stipulation of Facts, Exhibit M.

[2] As of March 31, 1988, in a move apparently intended to avoid state taxation of the settlement proceeds, Pennzoil Company conveyed all of its oil and gas assets to a new subsidiary, thereby converting itself into a holding company. The court considers that action and Pennzoil's holding company status irrelevant to the issues raised by the pleadings.

[3] The parties have stipulated that the amount in dispute is $2,088,840,687. (Stipulation of Facts at 1.)

ANALYSIS

Corporations doing business in Oregon are subject to an excise tax, measured by taxable income. ORS 317.070.[4] Pennzoil Company functioned as an operating company and was the reporting parent in the Oregon combined group. Because Pennzoil engages in business in more than one state, federal constitutional limitations on the state's jurisdiction to tax require its income to be apportioned.

To promote uniform taxation of interstate businesses, Oregon and a number of other states have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). *See* ORS 314.605 to 314.670. That statutory scheme provides the familiar three-factor formula for apportioning business income.[5] Nonbusiness income is not apportioned by a formula but is allocated based upon the source of the income. The critical question here is whether the tort settlement proceeds constitute business income.

ORS 314.610(1) states in part:

> " * * * 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and

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[4] All references to the Oregon Revised Statutes are to the 1987 Replacement Part.

[5] ORS 314.650(1) provides in part that:

> " * * * All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

> includes income from tangible and intangible property if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

ORS 314.610(5) states:

> " 'Nonbusiness income' means all income other than business income."

In construing a statute, the court's first duty is to ascertain the intent of the legislature. Normally, this is done by first looking to the text and context of the statute. *PGE v. Bureau of Labor and Industries*, 317 Or 606, 859 P2d 1143 (1993). However, UDITPA was adopted with the intent to achieve uniformity in the taxation of interstate businesses. Accordingly, the legislature directs that:

> "(2) ORS 314.610 to 314.670 shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it." ORS 314.605.

On its face, that statute suggests that the decisions of other states construing UDITPA should be considered by this court.

The Oregon Supreme Court has indicated that the two basic goals of UDITPA are: "(1) fair apportionment of income among the taxing jurisdictions; and (2) uniformity of the application of the statutes." *See Twentieth Century-Fox Film v. Dept. of Rev.*, 299 Or 220, 227, 700 P2d 1035 (1985). Thus, the Oregon Supreme Court has concluded that the legislature intended fairness and uniformity to be the guiding standards.

Oregon is also a member of the Multistate Tax Compact (MTC), a cooperative effort between some states to reduce administrative costs of auditing interstate businesses and to increase uniformity of interstate taxation. *See* ORS 305.655 through 305.685. The MTC has recommended a rule defining business income that Oregon has adopted as OAR 150-314.610(1) – (B). That rule provides in relevant part:

> " * * * The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, capital gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business. In general, *all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business* and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. * * * " (Emphasis added.)

The validity of this rule was challenged in *Atlantic Richfield Co. v. Dept. of Rev.*, 300 Or 637, 645, 717 P2d 613 (1986). In that case, the Oregon Supreme Court held that the rule would be upheld if: "(1) the application of the

formula by the department reasonably approximates the taxpayer's income in Oregon, and (2) the application of the rule by the department 'effectuates [the] general purpose to make uniform the law of those states which enact [UDITPA].' " *Id.* At 645. This broadly worded rule suggests that "fairness" is grounded in the elements of the business and how those elements relate to each other. If the elements are interrelated as part of an integrated or unitary business, the rule would tax all income produced by that business.

Oregon's power to tax is limited by the due process and commerce clauses of the United States Constitution. When imposing an income-based tax on an interstate business, a state may not tax value earned outside its border. *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 US 307, 315, 102 S Ct 3103, 73 L Ed 2d 787 (1982). However, where a single integrated business operates in more than one state, its entire net income may be fairly apportioned among the states in which it operates. *Northwestern States Portland Cement Co. v. Minnesota*, 358 US 450, 79 S Ct 357, 3 L Ed 2d 421 (1959).

> " * * * [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 US 425, 439, 100 S Ct 1223, 63 L Ed 2d 510 (1980).

The unitary business principle provides the "minimal connection" needed to satisfy both due process and the commerce clause. It is the "rational relationship between income attributable to the state and the interstate values of the enterprise." *Exxon Corp. v. Wisconsin Dept. of Rev.*, 447 US 207, 219-20, 100 S Ct 2109, 65 L Ed 2d 66 (1980). In

commenting on this necessary relationship, the US Supreme Court in *Container Corp. v. Franchise Tax Bd.*, 463 US 159, 166, 103 S Ct 2933, 77 L Ed 2d 545 (1983) stated in part:

> " * * * [T]he principles we have quoted require that the out-of-state activities of the purported 'unitary business' be related in some concrete way to the in-state activities. The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation."

In that same case the court noted that UDITPA's definitions of business income and nonbusiness income "track in large part the principles we have just discussed." *Id.* at 167. It therefore appears that the fairness required by the United States Constitution is found in the elements of the business, i.e., a unitary relationship. It also appears that applying constitutional standards would achieve some measure of uniformity because every state must comply with the requirements of the United States Constitution.

In light of all of the above, the court concludes that the Oregon legislature intended to tax interstate businesses to the extent allowed by due process and the commerce clause. The legislature has evidenced this intent in regard to other provisions of UDITPA. *See Maytag Corp. v. Dept. of Rev.*, 12 OTR 502 (1993).

This conclusion impacts the court's construction of ORS 314.610(1). Specifically, ORS 314.610(1) has two separate clauses that most jurisdictions view as imposing two separate tests. The first clause adopts a transactional test, i.e., whether income arises from transactions and activities in the regular course of the trade or business. The second clause incorporates a functional test, i.e., income from property is business income if the acquisition, management, use, or rental and disposition of the property constitute an integral part of the regular trade or business. As indicated, some jurisdictions apply only the transactional test, whereas other jurisdictions apply both tests. *See* I Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, ¶ 9.05[2] at 9-33 (3rd ed 1998).[6]

Although no Oregon court expressly so holds, ORS 314.610(1) has been construed as incorporating both the transactional and functional test. *See Simpson Timber Company v. Dept. of Rev.*, 13 OTR 315 (1995), aff'd 326 Or 370, 953 P2d 366 (1998). This court believes the legislature recognized the compelling policy reasons for the functional test and intended it to be used when it adopted ORS 314.610(1).

In applying the transactional test, the first question is: from whence did the income arise? Pennzoil contends that the tort lawsuit was the transaction or activity giving rise to the income. However, Pennzoil ignores a clearly

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[6] The authors acknowledge the functional test but do not believe it can be justified based on the language. They state: "[i]n short, despite the compelling policy reasons for adoption of the functional test, we do not believe that the language of UDITPA authorizes it." *Id.* at 9-45.

established principle that is found in both federal and state income tax laws. That principle is: amounts received in litigation have the same character for income tax purposes as if collected without the necessity of lawsuit. *Hort v. Commissioner,* 313 US 28, 61 S Ct 303, 85 L Ed 1168 (1941). Certainly a lawsuit to collect money owing on an open account for purchases of goods does not convert the income collected to something other than proceeds from the sale of goods. Likewise, damages received as compensation for loss of profits due to a tort or breach of contract are taxable as ordinary income. *Mertens Law of Federal Income Taxation* § 24A:23.

UDITPA is merely an accounting method for taxing the income of interstate businesses. It does not extend the state's jurisdiction to tax, provide a new form of tax, or change the character of income for taxation purposes. Therefore, it should not be construed to change the character or source of income.

> " * * * In determining how damages recovered through litigation or settlement are treated for federal income tax purposes, courts have generally resolved that issue by asking: 'In lieu of what were the damages awarded?' " Hellerstein at ¶ 9.13[2][a].

That was the principle applied in *Simpson Timber Company v. Dept. of Rev.,* 13 OTR 315 (1995), aff'd 326 Or 370, 953 P2d 366 (1998) and in *Polaroid Corp. v. Offerman,* 349 N C 290, 507 SE2d 284 (1998), cert denied, 119 S Ct 1576 (1999).

The preponderance of the evidence in this case establishes that the income arose from Pennzoil's agreement with Getty Oil Company (Getty contract). The existence

of the Getty contract gave Pennzoil a right to damages for its breach and a right to damages for improper interference. Except for that contract, there would be no recovery and no income.

Initially, Pennzoil sued Getty Oil for specific performance. Failing to obtain that, Pennzoil then sued Texaco for interference of contract. In the Texaco suit, Pennzoil claimed damages for loss of bargain on the Getty contract based on the amount that Pennzoil would have saved in finding and developing 1 billion barrels of oil reserves. (Def's Ex FF at 48-49.) It is the same as if Pennzoil said to Texaco: you stole our deal, pay us what we would have benefitted. (TR at 60.) In the court's view, it does not matter whether the contract was sold, stolen, condemned, interfered with, or canceled; the income realized from it by Pennzoil was income "arising from" that contract.

The next question under the transactional test is whether negotiation of the contract with Getty Oil Company was an activity or transaction in the regular course of Pennzoil's trade or business. To answer this question, the court must consider what constitutes Pennzoil's regular trade or business.

Pennzoil offered no specific evidence as to how often or what kinds of agreements it negotiates for the sale or acquisition of oil and gas assets. However, some of the evidence touches upon the nature of Pennzoil's business. Pennzoil's offer to purchase the Getty stock stated:

> " * * * Pennzoil is a natural resource company engaged in oil and gas exploration and production, in processing, refining and marketing of oil and gas and refined petroleum products and in

mining and processing of copper, molybdenum, silver, gold, sulfur and potash." (Stipulation of Facts, E at 8.)

Pennzoil's explanation of how it proposed to pay for the Getty Oil stock indicates that most of the funds were to come from a production payment representing the sale of interests in numerous oil and gas leaseholds and fee interests. (Stipulation of Facts, E at 9-10.) Also, various activities mentioned in Pennzoil's annual reports (Def's Ex AAA-GGG) are consistent with the activities of a large oil and gas company that regularly engages in transactions and activities to acquire, use, or dispose of oil and gas assets. For example, in its 1984 annual report, the year the Getty contract was entered into, Pennzoil reports that it "participated in a number of major oil and gas plays, both domestically and internationally." (Def's Ex BBB at 8.)

Pennzoil obviously follows the industry practice of acquiring participating interests in various projects or assets and forming partnerships for acquisitions and operations of oil and gas assets. (Def's Ex BBB at 36.) All of these descriptions suggest that acquiring interests in oil and gas properties or in properties having potential for oil and gas is one of the elements of Pennzoil's regular trade or business.

Texaco argues that the contract was to acquire stock, not oil and gas assets. However, it is clear that the plan was to add the Getty Oil reserves to Pennzoil's inventory. (Def's Ex JJJ at 8.) Buying the Getty Oil stock was just a less expensive way of obtaining reserves (Def's Ex KKK at 138). In the Texaco trial, Hugh J. Liedtke, the chief

executive officer of Pennzoil and principal negotiator, testified:

> "Now, if * * * if we felt that we would have to own the stock forever, no, we wouldn't pay that for it. But we had, in our agreement, the ability to get assets and that's really what we're after. Principally oil and gas assets." (Def's Ex KKK at 144.)

When asked if the intent was to own the stock, or was it a way to purchase assets, he answered "[w]ell, the answer is we were after assets only. You had to buy some stock first to get there." (Def's Ex KKK at 144.)

Although the Getty contract was large, perhaps the largest ever negotiated by Pennzoil and certainly the richest, the preponderance of the evidence indicates that the transaction was in the course of its regular trade or business. The creation of that valuable asset by the efforts of Pennzoil's officers and employees through negotiation is no different than the discovery of a new oil field by its engineers or a new method of marketing by its sales staff. Pennzoil regularly acquires, develops, and uses oil and gas assets and that is precisely why it entered into the Getty contract. The court finds that negotiating the Getty contract was an activity in the regular course of Pennzoil's unitary business. Any income arising from that transaction or activity is business income apportionable under UDITPA.

Under the functional test, the question is: does the acquisition, management, use or rental, and disposition of intangible property such as the Getty contract constitute an integral part of Pennzoil's regular trade or business? As indicated above, the preponderance of the

evidence demonstrates that Pennzoil regularly acquires, uses, and disposes of contracts, stock, partnership interests, leases, and other interests in oil and gas assets. In the Texaco trial, the chief executive officer testified that he negotiated such purchases and sales many times over the years. (Def's Ex MMM at 32.) The officers of Pennzoil spent many years trying to "grow" the company (Def's Ex KKK at 85) and had previously had joint operations with Getty Oil Company. (Def's Ex KKK at 104.)

As one example, in 1983, Pennzoil, with a group of other "institutional and other investors," formed Proven Properties, Inc. for the purpose of acquiring and operating oil and gas producing properties. (Def's Ex EE at 8.) During 1984, Proven Properties, Inc. purchased interest in three Gulf of Mexico offshore oil leases and "various interests" in onshore gas producing properties. (Def's Ex EE at 8.) In the trial in this court, Baine P. Kerr, president of Pennzoil when the Getty contract was negotiated, testified that Pennzoil might have been able to form a joint venture or partnership with Getty. (TR at 46.) He also indicated that reserves are very important to Pennzoil (TR at 52) and that Pennzoil has leases for oil and gas numbering in the thousands. (TR at 51.)

It is clear that before, during, and after 1984, Pennzoil was actively engaged in acquiring and disposing of interests in oil and gas assets as an integral part of its regular trade or business. It is also clear that the form of those acquisitions, whether stock, partnership interests, or otherwise, is immaterial. The court finds that the Getty contract was intangible property whose acquisition, use, and disposition constituted an integral part of the Pennzoil's regular trade or business. Except for the size and

richness of the prize, it was no different than any number of other transactions over the years.

Applying the functional test, did the income come "from" that intangible property? Again, Pennzoil contends that the settlement income came from a lawsuit for tortuous [sic] interference with contract and not from the contract itself. The court acknowledges that a claim for improper interference of contract is different from a claim for breach of contract. The two claims involve different parties, different tests for recovery, and to some extent, different measures of damages. However, the issue is not whether they are different claims. The issue is the source or origin of income. If the income arose from the Getty contract, any actions Pennzoil may have had to take in order to collect that income is irrelevant to its character or nature for income tax purposes.

Despite Pennzoil's arguments to the contrary, the court finds that *Simpson Timber* and *Polaroid* are very relevant. In *Simpson Timber,* the government took the taxpayer's property by power of eminent domain. 13 OTR 315 (1995), aff'd 326 Or 370, 953 P2d 366 (1998). In *Polaroid,* Kodak infringed Polaroid's patent rights. 349 NC 290, 507 SE2d 284 (1998). In both cases, property of the taxpayer was taken or appropriated by another party and damages paid in lieu of that property. Those damages were business income. Here, Texaco misappropriated Pennzoil's property. The settlement between Texaco and Pennzoil was in satisfaction of all claims by Pennzoil including its suit for specific performance of its contract.

Pennzoil argues that it only held the Getty contract three days and therefore it could not have been an

integral part of its business. (Ptf's Post-Trial Brief at 38.) However, ORS 314.610(1) contains no time limits. What is particularly important about the Getty contract is that it was not property acquired from outside the business like an oil derrick or piece of refinery equipment that had to be integrated into the unitary operation. Its very creation was a result of Pennzoil's unitary business activities. Consequently, it was inherently an integral part of Pennzoil's regular trade or business.

Pennzoil contends that taxation of the settlement proceeds violates the United States Constitution on two separate grounds. First, it contends Oregon has no nexus or minimal connection with the settlement proceeds, therefore it is taxing value earned outside of Oregon. This argument erroneously assumes that the income is not from the Getty contract. Because the income does arise from the Getty contract and that contract was part of Pennzoil's regular trade or business, the unitary business provides the required nexus with Oregon. Pennzoil's oil wells in Louisiana and offshore of California are economically integrated with the packaging and selling of oil in Oregon. Any gains or losses suffered by one part of the unitary business are suffered by the whole.

Pennzoil assumes that its operations in Oregon had no connection with negotiating the Getty contact in New York. Nothing could be further from the truth. Regardless of the negotiating skills of Pennzoil's officers and employees, a contract with Getty Oil was possible only because of Pennzoil's unitary business. Without that business, Pennzoil's negotiators had nothing to offer and nothing to bring to the proposed merger table. It is the very "sharing or exchange of value not capable of precise

identification or measurement" that makes Pennzoil's interest in the contract a unitary interest. *Container Corp.* at 166. Consequently, no one part of the integrated business and no one location can be identified as nonessential in the negotiating activity that gave rise to the Getty contract. The values, expectations, synergies, markets, and other characteristics of the Oregon operations were mingled with and as involved as any other part of the Pennzoil business.

Pennzoil cites *Allied-Signal v. Director, Tax Div.*, 504 US 768, 112 S Ct 2251, 119 L Ed 2d 533 (1992) as authority for arguing that no unitary relationship exists between Getty Oil and Pennzoil.[7] Again, Pennzoil is looking beyond the mark. The Getty stock was not acquired, therefore no income arose from that stock. The only thing acquired were contract rights and contract obligations under the Getty contract. Therefore, the Getty contract must be the source of income. The only question under *Allied Signal* is whether the Getty contract served an operational function or an investment function.

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[7] There is no doubt that if Pennzoil had acquired the Getty stock, there would be a unitary relationship.

> " * * * When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources." *Container Corp. v. Franchise Tax Bd.*, 463 US 159, 178, 103 S Ct 2933, 77 L Ed 2d 545 (1983).

> " * * * That is the relevant unitary business inquiry, one which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785.

Because the Getty contract was created by and arose out of Pennzoil's unitary business, there is no doubt that it served an operational function.

Pennzoil's second constitutional argument is that inclusion of the settlement income results in such distortion that Oregon is effectively taxing value earned outside the state. Pennzoil asserts that the income is out of all proportion to activities that take place in the state. Of course, this argument would apply equally to *every* state in which Pennzoil conducts its business. The $3 billion settlement was such a large amount it would cause distortion in every state based on the "normal" business activities in that state. In essence, Pennzoil believes that the settlement was too big to be taxed.

Pennzoil's energetic arguments are driven primarily by the amount involved. There is no doubt that if Pennzoil had sold the Getty contract to Texaco for three hundred thousand dollars or even $3 million, it would have been treated as business income without hesitation. The fact that the amount was $3 billion suddenly makes any taxation seem wrong to Pennzoil. However, just because a unitary business suddenly realizes more income than normal does not make it nonunitary. The court can find no basis for separating transactions based on size alone.

Pennzoil's separate accounting purports to show that its operations in Oregon suffered a $1 million loss. Therefore, Pennzoil argues it is entirely wrong to attribute a $11.3 million income to such operations. In trying to gain some perspective on this argument, the court has looked at the company's revenues and net income for the years 1985 through 1988. They are as follows:

	1985	1986	1987	1988
Gross Revenue	$2,249.3	$1,921.2	$1,836.3	$2,273.9
Net Income	$ 113.2	$ 45.4	$ 44.3	$1,475.4

(Expressed in Millions)

(Def's Ex EEE at 3, Ex FFF at 3.)

From the above figures, it is apparent that Pennzoil's gross income in 1988 was only 24 percent higher than 1987 and almost the same as the gross income in 1985. However, the net total income for the company was 33.3 times greater in 1988 than in 1987, more than a 3,200 percent increase over the prior year. The earnings per share reported in the same exhibits show that the amount per share was 5,300 percent greater. These increases result in a company-wide "distortion" that, using Pennzoil's logic, cannot be justified by any state in which the company does business. But the fact of the matter is the unitary business received more income than its operations normally produce. Because this income was earned by the whole company, it must be apportioned to every state in which it conducts business. In this light, the 3,200 percent increase in total net income is significantly greater than the 1,877 percent "distortion" Pennzoil calculates for Oregon. Although the net income in 1988 was

extraordinary, there is nothing inherently unfair in apportioning it. As noted above, except for the unitary business, there would have been no Getty contract.

Pennzoil argues that even if the settlement proceeds are business income, the court cannot justify attributing $11.3 million income to instate activities that actually operated at a loss. (Ptf's Rely Brief at 6.) This argument attacks the unitary business principle on two points. First, it assumes that separate accounting is accurate when the very reason for adopting the unitary principle was recognition that it is not. It has long been established that separate accounting on a geographical or transactional basis may not reflect the true economics of an integrated business in any particular jurisdiction.

Second, it assumes that extraordinary transactions can be severed from the unitary business. This assumption would unravel the unitary principle. If a unitary business operated at a loss overall, but one state could identify an extraordinary single transaction or series of transactions in that state which resulted in a gain, would that state be justified in separately taxing the gain? How large or small must such transactions be to justify separate accounting? If specific transactions were taxed by one or more states, how would this affect the losses apportionable to other states? These are unanswerable questions whose very asking suggests that this approach is contrary to accepted principles of interstate taxation.

In summary, it is undisputed that Pennzoil is a unitary business involving a flow of value interstate that cannot be precisely measured. It is undisputed that Pennzoil does business in Oregon and therefore its business

income is apportionable to Oregon. Finally, it is undisputed that Oregon's three factor formula fairly reflects the way in which income is earned by Pennzoil. These undisputed facts lead to an indisputable conclusion: Pennzoil's business income is taxable in part by Oregon.

The court has found that the income in question had its source in the Getty contract and that the Getty contract was created in the regular course of Pennzoil's business. Therefore, the income is business income as defined by ORS 314.610(1) and is apportionable.

The second issue that must be addressed by the court is whether the gross proceeds from the financial instruments involved are includible in the denominator of the sale factor. Pennzoil claims that this issue is controlled by *Sherwin-Williams Co. v. Dept. of Rev.*, 14 OTR 384 (1998), aff'd 329 Or 599, ___ P2d ___ (1999). The court agrees.

Judgment will be entered consistent with this Opinion. Costs to neither party.

Dated this 17th day of March, 2000.

/s/ Carl N. Byers
Carl N. Byers
Judge

APPENDIX C

OREGON REVISED STATUTES INVOLVED*

314.610 Definitions for ORS 314.605 to 314.675. As used in ORS 314.605 to 314.675, unless the context otherwise requires:

(1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(2) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(3) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(4) "Financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, credit union, cooperative bank, investment company, or any type of insurance company.

(5) "Nonbusiness income" means all income other than business income.

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*The Oregon revised statutes reproduced in this Appendix are the versions that existed during the period at issue.

(6) "Public utility" means any business entity whose principal business is ownership and operation for public use of any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas.

(7) "Sales" means all gross receipts of the taxpayer not allocated under ORS 314.615 to 314.645.

(8) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

314.615 When allocation of income from business activity required. Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion the net income of the taxpayer as provided in ORS 314.605 to 314.675. Taxpayers engaged in activities as a financial organization or public utility shall report their income as provided in ORS 314.280 and 314.675.

314.650 Formula for apportionment of business income. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

314.670 Additional methods to determine extent of business activity in this state. If the application of the allocation and apportionment provisions of ORS 314.610 to 314.665 do not fairly represent the extent of the taxpayer's business activity in this state, and result in the violation of the taxpayer's rights under the Constitution of this state or of the United States, the taxpayer may petition for and the department may permit, or the department may require, in respect to all or any part of the taxpayer's business activity:

(1) Separate accounting;

(2) The exclusion of any one or more of the factors;

(3) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

317.018 Statement of purpose. It is the intent of the Legislative Assembly:

(1) To make the Oregon corporate excise tax law, insofar as it relates to the measurement of taxable income, identical to the provisions of the federal Internal Revenue Code of 1986, as amended on or before December 31, 1986, even where the amendments take effect or become operative after that date, to the end that taxable income of a corporation for Oregon purposes is the same as it is for federal income tax purposes, subject to Oregon's jurisdiction to tax, and subject to the additions, subtractions, adjustments and modifications contained in this chapter.

(2) To achieve the results desired under subsection (1) of this section by application of the various provisions of the federal Internal Revenue Code relating to the definitions for corporations, of income, deductions, accounting methods, accounting periods, taxation of corporations, bases and other pertinent provisions relating to gross income. It is not the intent of the Legislative Assembly to adopt federal Internal Revenue Code provisions dealing with the computation of tax, tax credits or any other provisions designed to mitigate the amount of tax due.

(3) To impose on each corporation doing business within this state an excise tax for the privilege of carrying on or doing that business measured by its federal taxable income as adjusted in this chapter.

APPENDIX D

EXPERT OPINION OF PROFESSOR RICHARD D. POMP[1]
Pennzoil Company and Subsidiaries v. Dept. of Revenue, State of Oregon

Introduction

You have contacted me as the former Director of the New York Tax Study Commission and as someone who for nearly 25 years has studied, lectured, taught, published, and consulted with, and testified on behalf of state governments, regarding issues of state taxation. Specifically, you have asked my opinion on how the receipt of a cash settlement of $3 billion in cash paid by Texaco to Pennzoil should be treated by Oregon under normative principles of state tax policy.

This issue arises out of one of the most extraordinary events in recent corporate history: Texaco's illegal interference with Pennzoil's agreement to purchase 3/7 of Getty Oil stock. In a suit brought by Pennzoil against Texaco, originally filed in Delaware but later brought in Texas, a jury awarded Pennzoil a record $11.12 billion in damages.

After the jury verdict, the lawsuit followed a complex path, involving state and federal courts, including the U.S. Supreme Court. In order to avoid paying the jury award, Texaco filed in New York for reorganization protection under the federal bankruptcy laws. Ultimately, in 1988 Pennzoil accepted a $3 billion cash settlement in

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[1] Alva P. Loiselle Professor of Law, University of Connecticut Law School; Adjunct Professor of Law, NYU Law School (LL.M Program in Taxation); Adjunct Professor of Law, Columbia Law School.

order to avoid the delays and uncertainties inherent in further judicial proceedings. This amount was nearly 8 times Pennzoil's operating income in that year. These unprecedented events spawned at least two books and countless articles both in the lay press and in the business press.

Analysis

A. The Settlement Proceeds Have No Connection or Relationship With Oregon

The Oregon Department of Revenue wishes to include the amount of the settlement proceeds in the income that Pennzoil apportioned in 1988 to Oregon. Under normative principles of tax policy, Oregon can apportion the cash settlement only if there is a sufficient relationship between itself and the proceeds it seeks to tax. There must be some link or connection between Oregon and the proceeds. Otherwise, Oregon will not have provided any benefits to Pennzoil associated with the settlement proceeds for which Oregon can exact a tax as a quid pro quo. Consequently, it is necessary to examine the relationship between Oregon and the events culminating in the receipt of the $3 billion of cash to determine whether a sufficient link exists.

In 1988, Pennzoil's activities in Oregon consisted only of the marketing of filtration products, motor oil, and related products. The settlement proceeds at issue arose out of an attempt by Pennzoil to purchase 3/7 of Getty Oil stock. That purchase was frustrated because of the illegal actions by Texaco.

None of the events surrounding the attempt by Pennzoil to purchase the Getty stock, Texaco's tortious interference with those attempts, or the ensuing litigation, culminating with the payment of the $3 billion settlement, had anything to do with Pennzoil's activities in Oregon, or with any business, part of which was conducted in Oregon. Pennzoil is incorporated in Delaware and is commercially domiciled in Texas. None of the negotiations over the purchase of the Getty stock took place in Oregon. None of Pennzoil's executives involved in the negotiations was a resident of Oregon. None of the meetings of Pennzoil's Board of Directors dealing with the purchase of Getty stock took place in Oregon. None of Texaco's illegal activities occurred in Oregon. No Oregon-based employee of either Pennzoil or Texaco had anything to do with any of the state or federal litigation that resulted in the payment of damages. None of the voluminous litigation took place in Oregon. The suit against Texaco had nothing to do with the marketing of motor oil and related products in Oregon. In short, Oregon had no connection or relationship to the settlement proceeds that Pennzoil received from Texaco.

B. The Litigation did not Arise out of Pennzoil's Everyday Business Operations

The Texaco litigation did not arise out of the ordinary everyday business operations of Pennzoil, as might be true, for example, of a product liability suit. Nor was this a situation involving litigation to recover lost business profits, such as a suit against a party infringing Pennzoil's trademark. Rather, this "bet the farm" litigation,

which drove Texaco into bankruptcy, was an extraordinary event, not only in the life of Pennzoil, but also in the history of corporate America.

C. Speculation Over What Might Have Happened Cannot Substitute for Analyzing What Actually Did Happen

I understand that the Oregon Department of Revenue is attempting to circumvent Oregon's lack of any relationship to the settlement proceeds by ignoring what *actually happened* and instead by speculating about [sic] *might have happened* if Pennzoil had been successful in actually acquiring the Getty stock. But if Oregon is free to speculate about what might have happened then so is Pennzoil. For all anyone knows, if Pennzoil had acquired the Getty stock it might have turned around and immediately sold it to Texaco in response to an offer it could not refuse. Under that scenario, Oregon would have had no claim to taxing any of the gain on the sale.

The point is not whose speculative scenario should control, an issue that is not amenable to logic. Instead, the point is to determine whether Oregon had any connection with the events that actually did occur. Texaco's illegal conduct deprived Pennzoil of an opportunity to have used the Getty stock for whatever purposes future events might have dictated. Those future events might – or might not – have resulted in the stock generating income that would have been apportionable to Oregon. The reality, however, is that Pennzoil never received the stock, nor did it even receive the full amount of the damages

awarded to it by the Texas jury. And the cash that it did receive as a settlement had no connection to Oregon.

D. The Measure of Damages at Trial is Irrelevant to Whether the Settlement Proceeds can be Taxed by Oregon

In the Texas litigation, the measure of damages requested by Pennzoil was based in part on the amount of Getty's oil reserves. Because of its litigating strategy, Texaco chose not to address the issue of damages at all. Hence, the only evidence before the jury was that introduced by Pennzoil.

Apparently, the audit division feels that because the damages awarded by the jury were based in part on the amount of oil reserves owned by Getty, the settlement proceeds should be treated as if Pennzoil had received the oil and sold the oil for a profit equal to the settlement proceeds it received. This argument assumes: 1) that Pennzoil would not have sold the Getty stock prior to actually acquiring the oil reserves; 2) that if Pennzoil owned the Getty stock it would have obtained the reserves; 3) that the amount of the reserves was identical to the uncontested amount offered into evidence during the Texaco trial; 4) that Pennzoil's costs of developing those reserves was identical to the uncontested amount offered into evidence at the Texaco trial; 5) that Pennzoil would have used the oil in a manner that would have generated a profit and not a loss; and 6) that any profits generated by the oil would have been properly taxable by Oregon. Obviously, this argument is built entirely upon a

series of assumptions that have nothing to do with what actually did occur.

More fundamentally, Pennzoil lost the value of the Getty stock it thought it had purchased. The value of stock in an oil company like Getty will typically be a function of that company's oil reserves. The value of a corporation's stock is related to the value of its assets and one of the assets of an oil company is its reserves. Whether damages are measured by the fair market value of a corporation's stock, or by the value of the assets that underlie the stock, should have no bearing on whether the damages are taxable. Regardless of the measure of damages, a sufficient relationship must still exist between the damages and the taxing state. And that relationship must be based on facts that exist, not on those that might be imagined.

An equally fatal defect in the audit division's position is that Pennzoil did not receive the damages awarded by the jury but instead received a cash settlement in lieu of those damages. I do not know – and I suspect that the audit division does not know – exactly how the parties determined the amount of that settlement. All that is known is that cash was paid by Texaco to Pennzoil in settlement of the litigation. And in my opinion, that settlement has no connection or relationship with Oregon.

E. Taxing the Settlement Proceeds Would be Inconsistent with the Principles Underlying Oregon's Apportionment Formula

The policy considerations underlying Oregon's three factor apportionment formula require that the settlement

proceeds not be apportioned to Oregon. Oregon's apportionment formula works acceptably well for dealing with the everyday business profits of a business. Those profits can be viewed as being generated by the payroll, sales, and property of the business. Oregon's share of each respective factor can be viewed as helping to generate the ordinary profits of the business. Consequently, there is a matching between the income and the factors that helped generate that income.

No Oregon factor, however, helped generate the settlement proceeds that the State is now seeking to tax. Moreover, the settlement proceeds were not associated with any business, part of which was conducted in Oregon. There was no Oregon property or payroll that had any relation to the receipt of the cash payment. Furthermore, Pennzoil has been fully consistent in its characterization of the settlement proceeds because it did not deduct in Oregon any of its litigation expenses that ultimately led to the receipt of the settlement proceeds.

There is another related policy reason why the settlement proceeds should not be apportioned to Oregon. The Oregon apportionment formula, like all apportionment formulas, is hardly scientific. There is no economic theory or model upon which the formula is based and no principle that dictates, for example, that the factors should be equally weighted. One of the reasons, however, that makes the formula workable and acceptable is that as long as it is applied to everyday, recurring business profits, any errors or slippages in the formula are likely to wash out. That is, in one year the formula may overstate the contribution of Oregon labor to generating the

corporation's everyday profits and understate the contribution of Oregon property. In another year, the formula may overstate the contribution of Oregon property and understate the contribution of Oregon labor. Over time, however, these differences are likely to offset one another.

The $3 billion of settlement proceeds received by Pennzoil in 1988 was nearly eight times its operational income. The proceeds cannot be viewed as part of its everyday, recurring business profits. Slippage in the Oregon formula will not be self correcting because Pennzoil never received a settlement of this magnitude either before – or subsequent to – the Texaco suit. The obvious overreaching of the Oregon formula that would result if applied to the $3 billion of proceeds is not insignificant, nor can any overreaching be ignored on the grounds that in the future the formula will self correct by underreaching income to which Oregon would otherwise have a legitimate claim.

Conclusion

The $3 billion of cash paid by Texaco to Pennzoil in settlement of their protracted litigation had no connection or relationship with Oregon. The payment arose out of an attempt by Pennzoil to purchase 3/7 of Getty Oil stock and was frustrated through the illegal actions of Texaco. None of the events surrounding the attempt by Pennzoil to purchase the Getty stock, Texaco's tortious interference with those attempts, or the ensuing litigation and ultimate settlement had anything to do with Pennzoil's activities in Oregon.

The Department of Revenue seeks to apportion the settlement proceeds to Oregon based on what might have

happened had Texaco not interfered with Pennzoil. But tax consequences cannot be based on speculation about what might have happened – only on what actually did happen. And what actually did happen was that Texaco settled the Pennzoil litigation by paying $3 billion in cash – events having nothing to do with Pennzoil's activities in Oregon.

In addition, the Department's position is inconsistent with the principles underlying Oregon's apportionment formula. No Oregon factor helped generate the cash payment by Texaco. Moreover, the 1988 settlement, nearly eight times Pennzoil's operating income in that year, cannot be viewed as part of its everyday, recurring business profits.

Consequently, in my opinion the settlement proceeds paid by Texaco have no relationship with Oregon and should not, under normative principles of state tax policy, be apportioned to that State.

APPENDIX E

EXPERT REPORT OF WALTER HELLERSTEIN

Prepared for Morrison & Foerster
Counsel for Pennzoil Company & Subsidiaries

in connection with

Pennzoil Company and Subsidiaries
v.
Department of Revenue

No. 4301

Before the Oregon Tax Court

Based on a review of various documents produced by the parties in this case, and relying on materials regularly and reasonably relied upon by persons in my field and on my own knowledge of the limitations on state taxation, the following constitutes my report of my opinions and conclusions at this time.

The Texaco Settlement Proceeds

It is my opinion that Oregon has no authority to tax the Texaco Settlement Proceeds. My opinion rests on the fundamental requirement of state taxing power that there must be some definite link or minimum connection between a state and both the person and the activity that the state seeks to tax. It is well settled that in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the state seeks to tax.

The underlying rationale for this virtually axiomatic proposition is that the exercise of a state's tax power over a taxpayer's activities is justified by the protection,

opportunities and benefits the state confers upon such activities. If the state lack [sic] the definite link or minimum connection with the activities in question, it has not given anything for which it can ask return.

In this case, Oregon lacks the authority to tax the Texaco Settlement Proceeds because it lacks the definite link or minimum connection with the activity that produced those proceeds. The activity that produced the Texas [sic] Settlement Proceeds had no connection with Oregon. That activity was a lawsuit about an effort to acquire stock (and, ultimately perhaps, assets) that Pennzoil sought to acquire so that it might use the stock (and, perhaps the assets) in its business *in the future*.

It is plain, of course, that the lawsuit itself did not occur in Oregon. Assuming, however, that one should look to the Getty stock and the underlying Getty assets that were the focus of the lawsuit – rather than to the lawsuit itself – in determining whether Oregon has a definite link or minimum connection with the Texaco Settlement Proceeds, the conclusion is clear that Oregon lacks a sufficient connection with Pennzoil's abortive effort to acquire the Getty stock to enable Oregon to tax the proceeds of a settlement of lawsuit spawned by that abortive effort. The critical fact is that Pennzoil never acquired the Getty stock or its assets. There is therefore no basis for looking to the stock or the assets as generating income that was part of Pennzoil's business conducted in part in Oregon because such stock or assets were never used in Pennzoil's business.

To be sure, Pennzoil sought to acquire an interest in Getty and might have used that interest, had it acquired

such interest, to get access to Getty's reserves which it might then have used in its oil and gas business, and such reserves might then have generated income in Pennzoil's oil and gas business which conceivably could have been includable in Pennzoil's Oregon apportionable tax base. But those speculative facts are simply irrelevant to this case. The critical question for determining whether income from an asset is includable in a state's apportionable tax base is whether there is an organic connection between the asset and the taxpayer's *existing* business activity in the state. It is that link that assures that the state has provided some protection or benefit to the asset – through its protection of the business of which the asset is a part – and that justifies the state's apportioning income that otherwise has no palpable connection with the state. The possibility that assets *might* be used in a taxpayer's business *in the future* cannot provide the link that justifies a state's taxing them as if they were used in the business now.

Indeed, the facts here are indistinguishable in this respect from the leading case in which the Supreme Court held that a state lacks the power to include a taxpayer's income in the state's apportionable tax base. In that case, New Jersey sought to tax Bendix on the gain from its sale of ASARCO stock on the ground that the proceeds from the stock sale were used to acquire stock in Martin Marietta, which clearly would have been unitary with Bendix if the acquisition had been consummated. The Court found that the New Jersey Supreme Court had erred in relying on the fact that Bendix intended to use the gain from the sale of ASARCO to acquire Martin Marietta because the future use of these proceeds reveals little

about whether the ASARCO stock was used in Bendix's *current* business – the touchstone of the proper [sic] of a state's power to tax a multistate taxpayer's income.

Nor does the fact that the damages were measured by the economic benefit to Pennzoil of acquiring Getty's reserves affect the analysis. The yardstick for determining income has no bearing on the source of the income. If my law school salary were measured by the posted field price of West Texas Intermediate crude oil, that would not subject me to tax in Texas. By the same token, the fact that Pennzoil's damages may have been measured by the relative price of Getty's reserves and market prices tells us nothing about the geographical source of those damages.

In short, the only link between Oregon and the Texaco Settlement Proceeds is speculation about the future use that Pennzoil might have made of its planned – but ultimately abortive – investment in Getty. Such an attenuated connection does not constitute the minimum connection or definite link that is the prerequisite of Oregon's power to tax such proceeds.

It is also my opinion that Oregon has no authority to tax the Texaco Settlement Proceeds because such proceeds cannot reasonably be characterized as income arising from transactions and activity in the regular course of the taxpayer's trade or business or income from tangible and intangible property that constitutes integral parts of the taxpayer's trade or business. It is only such income which Oregon is authorized to tax with respect to a taxpayer that is not commercially domiciled in the state.

It would be hard to find a transaction that is less easily characterized as a transaction in the regular course of the taxpayer's trade or business or an integral part of the taxpayer's trade or business than a once-in-a-corporate-lifetime payment from the settlement of a lawsuit. Moreover, the results of controversies in other jurisdictions whose law is identical to Oregon's overwhelmingly supports the view that income from extraordinary or unusual transactions must be allocated and may not be apportioned. In fact, when states have desired to include in their apportionable tax bases the income from extraordinary transactions, they have been compelled to change the law to specify that such income is apportionable. In short, it is clear in Oregon (as in other states where the issue has arisen) that there is no authority to include the Texaco Settlement Proceeds in Pennzoil's apportionable tax base due to its extraordinary nature.

It is also my opinion that, because Pennzoil Company itself was engaged in no trade or business of any kind in April of 1988 when it received the Texaco Settlement Proceeds, those proceeds cannot be characterized as income arising from transactions and activity in the regular course of the taxpayer's trade or business or as income from tangible and intangible property that constitutes integral parts of the taxpayer's trade or business.

It is also my opinion that if the Texaco Settlement Proceeds were included in Pennzoil's Oregon apportionable tax base, the resulting apportionment would attribute to Oregon income out of all appropriate proportion to Pennzoil's activities in the state and create a grossly distorted result.

It is also my opinion that if the Texaco Settlement Proceeds were included in Pennzoil's Oregon apportionable tax base, inclusion of the settlement payments in the apportionment factors would be required in order to satisfy the requirement that an apportionment formula be fair and in order clearly to reflect income.

APPENDIX F

OFFICIAL TRANSCRIPT

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: ALLIED-SIGNAL, INC., AS SUCCESSOR-IN-INTEREST TO THE BENDIX CORPORATION, Petitioner V. DIRECTOR, DIVISION OF TAXATION

CASE NO: 91-615

PLACE: Washington, D.C.

DATE: April 22, 1992

* * *

[36] QUESTION: You are suggesting that States will not maximize their taxable authority?

MS. HAMILL: Well, you know, over the past 10 years, the States have really been sort of up against a wall with ASARCO and Woolworth and really losing large amounts of income out of the base. I think if you give the apportionment formula a chance to work, that the States will see that it has got to be used, particularly if all income in the base –

QUESTION: They will simply have to be reasonable; even if they weren't, they could get away with taxing more.

MS. HAMILL: Well, I don't think the world will ever be the same after ASARCO and Woolworth, and I

think the States have learned a lesson. You can't be too piggy. You have really got to realize that in some cases where [37] there is recurring – a huge, huge investment portfolio with none of the, none of the generative assets in the formula may very well create distortion.

But the States can and should deal with that. This Court can deal with it –

QUESTION: That will be our principle, you can tax whatever you like, but don't be too piggy.

(Laughter).

MS. HAMILL: I think the Court –

QUESTION: That will put the fear of the Lord in them.

(Laughter.)

MS. HAMILL: Again, though, I think that you ought to give the apportionment formula a chance to work and it may very well work, and you may though have a couple of apportionment cases where a State is being piggy and refuses to see the light, refuses to make any –

QUESTION: How do we decide then if it is being too piggy without some rules?

MS. HAMILL: I think that courts have managed to do it. Judge Cardozo sitting on the New York Court of Appeals had no trouble –

QUESTION: We thought that we had managed to do it already.

MS. HAMILL: You did, you certainly did. There [38] is no question that ASARCO and Woolworth in one sense, they are a very workable rule, they just plain –

QUESTION: Sort of workable I think.

* * *